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IN THE

Supreme Court of the United States

OCTOBER TERM 1942

No. 239

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

No. 240

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO REVIEW JUDGMENTS OF THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR WRITS OF CERTIORARI

To the Honorable Chief Justice and Associate Justices of the United States:

SUMMARY STATEMENT OF THE MATTER INVOLVED

This petition involves the interpretation of Section 115 (a), (b), (c), (g) and (i) of the Internal Revenue Code, i.e. what is or is not a distribution in partial liquidation and therefore not taxable as income. The distribution

here arose out of the reduction in capital and complete cancellation of part of an original issue of stock which occurred in 1914, long before the passage of Section 115 or its predecessors. There therefore could not have been any scheme, plan or motive which could have any relation to an avoidance of any tax. Section 115 (g), in order to make the distribution taxable, requires the *cancellation* to take place at such time and in such manner as to make the cancellation and distribution essentially equivalent to the distribution of a taxable dividend.

Moreover, Section 115 (g), on which the Circuit Court of Appeals below based its decision, was not in issue, argued, briefed, or even mentioned by anyone before the decision of that Court. Rehearing on this ground was denied, contrary to the rule laid down by decisions of this Court.

Your petitioners sued the respondent in separate actions in the United States District Court for the Southern District of Ohio, to recover excess income taxes paid for the calendar year 1934, arising out of certain payments made to their respective decedents, by The Karl Kiefer Machine Company, a corporation, in that year. Both cases involved issues arising out of the same transactions, and were, although separately tried, submitted together to the Court without a jury. One Findings of Fact and Conclusions of Law was made for both cases (R. 60-67, 87). Judgment was rendered for the respondent in each case (R. 67, 88). By stipulation the cases were presented on the same record upon appeal to the United States Circuit Court of Appeals for the Sixth Circuit (R. 89, 94) and were decided together by that Court (R. 94). The judgments of the District Court were affirmed (R. 93, 94).

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908 with an authorized capital of

$500,000, consisting of 3000 shares of common stock, par value $100, and 2000 shares of preferred stock, par value $100; on November 28, 1914, 1500 shares of the common stock, and 420 shares of the preferred stock were fully paid up, issued and outstanding, the total paid-in capital as of that date thus being $192,000. At that time, Karl Kiefer, now deceased, was the owner of 748 shares of the common stock, and Mrs. Rheinstrom, now deceased, was the owner of 748 shares of the common stock, the remaining four shares of common stock being in the names of others to qualify them as directors (R. 14-15, 80). All of the preferred stock was owned by Karl Kiefer (R. 83).

On November 28, 1914, at a special meeting of the stockholders of the company, at which all its outstanding stock was represented, it was unanimously resolved that the capital stock be reduced from $500,000 to $70,000, to consist of $42,000 preferred stock divided into 420 shares at $100 each, and $28,000 common stock divided into 280 shares at $100 each (R. 15, 81). On November 30, 1914, the Board of Directors of the company approved the action of the stockholders (R. 16, 81-82). Thereafter a certificate of reduction of capital stock was filed in the office of the Secretary of State, Columbus, Ohio, and on December 1, 1914, that officer issued his certificate showing that the reduction of the capital stock of the company had been made and recorded in his office (R. 17-18, 82-83).

Upon the filing of the certificate of reduction of capital stock, certificates representing 1496 shares of common stock of the Karl Kiefer Machine Company, being the 748 shares each owned by Minna W. Rheinstrom and Karl Kiefer, were delivered to the company and cancelled; new certificates for 276 shares of common stock of the par value of $100 each were issued by the company, certificates for 138 shares thereof being issued to Mrs. Rheinstrom, and

a like number to Karl Kiefer (R. 18, 83). The remaining four shares of the 280 shares of reduced common stock were beneficially owned, two shares each, by Mrs. Rheinstrom and Karl Kiefer, but were in the name of other persons to qualify them as directors (R. 80). Thus Mrs. Rheinstrom and Karl Kiefer each was the real owner of one-half of the common stock both before and after the reduction of capital, each returning a net of 610 shares of common stock for cancellation to the corporation. Karl Kiefer owned the entire outstanding preferred stock, which remained unchanged, namely 420 shares, both before and after the reduction in capital (R. 83).

The minutes of the meetings of the stockholders and directors of the Karl Kiefer Machine Company which record the action by which the reduction of its capital stock was accomplished are silent as to the motive which led to the taking of this action (R. 15-16, 81-82). At the trial, James Rheinstrom, who was a stockholder, director and secretary of the company in 1914, and who moved the adoption of the resolutions reducing the stock, proposed to testify that the purpose of the stockholders and directors in reducing the stock was to free that portion of the capital for the stockholders' use at any time they should desire to draw down this money (R. 31-32), but such testimony was excluded by the Court as in violation of the parol evidence rule (R. 30, 31, 41).

Karl Kiefer died on April 16, 1931, and under the provisions of his will, petitioner, the First National Bank as Trustee was left one-third of his estate in trust, to pay the income thereof to Adele Kiefer for life, and on her death to pay the principal to designated remaindermen (R. 84).

In 1934 in addition to paying to its stockholders as declared dividends from earnings on common stock the sum of $90,000.00, the Karl Kiefer Machine Company paid to Mrs. Rheinstrom and to the legatees of Karl Kiefer the

sum of $122,000 which it considered was in repayment for the cancellation of the 1220 shares of common stock (Pl. Exs. 5, 6-A, 6-B, 7), of which, $61,000, representing the 610 shares of her $100 par value common stock which had been cancelled, was paid to Mrs. Rheinstrom, and $20,333.33, or one-third of the $61,000 due Karl Kiefer for his 610 shares of similar stock, was paid to the petitioner bank as trustee under the will of Karl Kiefer (R. 14, 84-85).

It is conceded by petitioners that at the time this distribution was made, the corporation had on hand more than sufficient accumulated earnings since February 28, 1913, from which it could have made payments of like amounts.

When Minna W. Rheinstrom and the trustee bank received the sums of $61,000 and $20,333.33 respectively from the Karl Kiefer Machine Company, in 1934, they did not regard it as income; on the contrary they considered it as return of capital, that is, repayment by the company of the capital which had been used to purchase the common stock which they had owned and surrendered in 1914 pursuant to the resolutions heretofore referred to (R. 14-18, 80-85). Thereafter, however, respondent required them to file amended returns so as to include those sums as income for the year 1934 (R. 14, 85), claiming that the distributions in question were dividends from earnings under subsections (a) and (b) of Section 115 of the Revenue Act of 1934.

The Commissioner of Internal Revenue, however, in the case of another stockholder, Adele Kiefer, conceded upon her protest, that the distribution to the trustee bank was principal under the trust, and therefore not taxable to her as the life tenant entitled to receive all income under the trust (R. 59-60, 87).

Additional income taxes were paid on the respective amounts distributed, $24,528.39 by Mrs. Rheinstrom and $1310.95 by the trustee bank. Claims for refund were duly

filed with, and rejected by, the Commissioner of Internal Revenue. Mrs. Rheinstrom died, and these suits were accordingly brought.

OPINION OF THE COURTS BELOW

Opinion of the District Court

The District Court (Druffel, J.) in granting judgments for the respondent, adhered to its decision made during the trial, excluding the proffered evidence as to the purpose of the reduction in capital, saying in effect that the Court would not have been persuaded by it even if it had been admitted. The Court then held that the reduction of capital and cancellation of the 1220 shares of common stock effected no real change in the capital structure of the corporation or in the relative positions of the stockholders; further, that since winding up of the business was not contemplated, the cancellation of stock and subsequent distribution was not a "partial liquidation" under subsection (i) of Section 115 of the Revenue Act of 1934, and finally, that since the corporation had sufficient accumulated earnings since February 28, 1913, on hand from which to make the payment, under subsections (a) and (b) of Section 115, distribution of the $122,000 must be conclusively presumed to be dividends from earnings. The opinion of the District Court is found R. 60-67, and is reported in *33 Fed. Supp. 917 (1940)*.

Opinion of the Circuit Court of Appeals

The Circuit Court of Appeals in its opinion (McAllister, J.) unfortunately talks all around the various points it discusses, but seems unwilling to make forthright commitments of its own. This much, however, can be gleaned therefrom: The Circuit Court of Appeals affirmed the District Court not on any ground ever urged or even men-

tioned by the Government or by the District Court, but *sua sponte* found as a fact that the cancellation and distribution were essentially equivalent to a distribution of a taxable dividend under subsection (g) of Section 115; considered that the motive behind the cancellation, even if not tax avoidance, was immaterial, and ruled that the distribution was taxable. The Court also held that the exclusion of the proffered testimony of the purpose of the reduction in capital was harmless, because the District Court referred to it in its opinion, and because petitioner's counsel contended that even without evidence of the actual purpose, as a matter of law the fund created by the reduction in capital and cancellation of the stock belonged to the stockholders anyway. The Court likewise decided that the distribution was not in partial liquidation or properly chargeable to capital account under subsections (i) and (c) of Section 115.

The opinion of the Circuit Court of Appeals appears R. 94-105, and is reported in *125 Fed. (2d) 790 (1942)*.

Both the District Court and the Circuit Court of Appeals avoided passing upon the trustee bank's contention that the tax on the share of the distribution it received in effect charged remaindermen entitled to principal only with an income tax on funds conceded by the Government to belong to principal account, and therefore constituted a tax on capital, violating due process of law and the apportionment requirements of *Article I, Section 2, Clause 3, and Section 9, Clause 4*, of the Federal Constitution.

JURISDICTIONAL STATEMENT

The decision and judgments of the United States Circuit Court of Appeals for the Sixth Circuit, affirming judgments of the District Court against the petitioners, were handed down February 13, 1942 (R. 93, 94). On March 14, 1942, less than thirty days thereafter, petitioners duly filed their

Petition for Rehearing with said Circuit Court of Appeals (R. 107). On April 17, 1942, said petition for rehearing was denied (R. 139). This petition was filed in the Supreme Court of the United States less than three months after said last date. This is a petition for writs of certiorari to review the judgments of the United States Circuit Court of Appeals for the Sixth Circuit in both cases, and is authorized by *Section 240(a)* of the *Judicial Code*, as amended by the *Act of February 13, 1925, c. 229, § 1, 43 Stat. 938* [*28 U. S. C. A. § 347(a)*].

STATUTE INVOLVED

The meaning of Section 115 of the Revenue Act of 1934 is in issue and that section is found beginning p. 23 of Appendix A to this petition.

QUESTIONS PRESENTED

1. May a Circuit Court of Appeals in an action at law, decide the appeal on an issue raised *sua sponte* by that court although not raised at any time by either party or by the lower court, and may the Circuit Court of Appeals go still farther and base its *sua sponte* ground on conclusions of fact made by it but not found by the lower court? Does such action by the Circuit Court of Appeals violate due process of law?

2. Is the purpose or motive for cancellation of part of an issue of stock material in determining whether or not such cancellation and subsequent distribution are essentially equivalent to the distribution of a taxable dividend under paragraph (g) of Section 115 of the Revenue Act of 1934?

3. Is paragraph (g) of Section 115 of the Revenue Act of 1934 applicable to a cancellation of stock *not issued as a stock dividend* where such cancellation occurred prior to January 1, 1926?

4. Is contemplation of closing out of a business necessary in order to have a distribution in partial liquidation under Section 115(i) of the Revenue Act of 1934?

5. Where a corporation reduces its capital and cancels part of its outstanding par value common capital stock, and some years later distributes to the holders thereof such par value in cash, is such distribution a return of capital?

6. If the corporation has on hand accumulated earnings since February 28, 1913, sufficient to make the payments, is such a distribution taxable under paragraphs (a) and (b) of Section 115 of the Revenue Act of 1934, or nevertheless not taxable as a distribution in partial liquidation and properly chargeable to capital account, under paragraphs (c) and (i) of the same Section?

7. Where a taxpayer claims that capital was reduced and cancellation of a part of an issue of stock was made in good faith and not for the purpose of evading a tax on dividends, but to make the capital thus freed available to the stockholders, can the Government raise the bar of the parol evidence rule against parol testimony of the purpose of the directors and stockholders in reducing the capital and cancelling the stock? Can exclusion of such evidence be held non-prejudicial merely because the trial judge says it would not have persuaded him even if admitted?

8. Does it violate due process of law and the apportionment requirements of *Article I, Section 2, Clause 3, and Section 9, Clause 4,* of the Federal Constitution, to cast the burden of an income tax on dividends upon remaindermen under a trust who are not entitled to receive dividends but entitled to receive capital only?

REASONS FOR ALLOWANCE OF THE WRITS

I

(a) The Circuit Court of Appeals below has so far departed from the accepted and usual course of judicial

proceedings as to call for an exercise of this Court's power of supervision in that the Circuit Court of Appeals decided the appeals in these cases on an issue raised *sua sponte* by it, although never urged or even mentioned at any time by either side or by the lower court. The Government's contention and the basis of the trial court's decision were that the reduction in capital effected no real change in the corporate structure or in the relative positions of the stockholders and that subsections (a) and (b) of Section 115 created a conclusive presumption in favor of the respondent. The Court of Appeals decided these cases upon the ground that the cancellation of stock and subsequent distribution occurred at such time and in such manner as to be essentially equivalent to the distribution of taxable dividends under paragraph (g) of Section 115 of the Revenue Act of 1934. Such contention had never been made in the cases at any time by the Government, either in the Department, the District Court, or in the briefs or argument in the Circuit Court of Appeals.

The pleadings in the case in the trial court appear at R. 1-13, 71-79. The opinion of the trial court is found at R. 60-67. The briefs filed in the Circuit Court of Appeals have been submitted as Appendix B to this petition. The Court can see by examining all the foregoing that the first time paragraph (g) of Section 115 was brought into the case was in the opinion of the Circuit Court of Appeals (R. 97). The petitioners never had the opportunity to meet such a contention. This was pointed out in petitioners' petition for a rehearing in the Court below (R. 123-4), but said petition was denied.

The action of the Court below deprived petitioners of due process of law and went contrary to the decisions of this Court in the cases of *Lutcher & M. Lbr. Co.* v. *Knight*, 217 U. S. 257, 267, 30 S. Ct. 505, 54 L. Ed. 757, 761 (1910); *West Ohio Gas Co.* v. *Public Utilities Com.*, 294 U. S. 63,

70, 55 S. Ct. 316, 79 L. Ed. 761 (1934); *General Utilities Co.* v. *Helvering*, 296 U. S. 200, 206, 56 S. Ct. 185, 80 L. Ed. 154 (1935).

(b) Further, the Circuit Court of Appeals exceeded its powers in that it based its decision upon a conclusion of fact found by it for the first time, although no such facts were found by the trial court.

The Circuit Court of Appeals found as a fact that the cancellation of the stock and distribution were essentially equivalent to a distribution of a taxable dividend. That this is a question of fact was decided in *Commissioner* v. *Babson*, 70 Fed. (2d) 304, 305, 306 (C. C. A. 7). As the Court can see from reading the findings of the trial court (R. 60-67), the trial court made no finding whatever in respect to any such contention. This Court has held on several occasions that the Appellate Court has no power in appeals in actions at law to make findings of ultimate fact which were not found by the trial court.

Helvering v. *Rankin, Executor*, 295 U. S. 123, 131, 55 S. Ct. 732, 79 L. Ed. 1343 (1935);
Commissioner v. *Pfeiffer*, 88 Fed. (2d) 3, 5 (C. C. A. 2, 1937), affirmed, 302 U. S. 247, 82 L. Ed. 231, 58 S. Ct. 159.

It is submitted that the action of the Circuit Court of Appeals presents very important questions of procedure and due process, and such action was contrary to the principles laid down in the decisions of this Court above cited.

II

The decision of the Circuit Court of Appeals is in conflict with the decisions of other Circuit Courts of Appeal on the same question. In the cases at bar, the cancellation of the stock occurred in 1914, long before the passage of Section 115, or any of its predecessors, and therefore, obviously, there could have been no motive of tax avoid-

ance behind the cancellation. Indeed, the Government has never so contended. Nevertheless, the Court below held that Section 115(g) was applicable to the case at bar. There is a conflict in the Circuits on the point of the materiality of motive to the question of the applicability of paragraph (g) of Section 115. The Circuit Court of Appeals referred to this conflict (R. 97, et seq.).

The Third and Fourth Circuits and the Court of Appeals of the District of Columbia and in some cases the Seventh Circuit have held motive immaterial.

Flanagan v. *Helvering*, 116 Fed. (2d) 937 (App. D. C., 1940);
Smith v. *U. S.*, 121 Fed. (2d) 692 (C. C. A. 3, 1941);
Hill v. *Commissioner of Int. Rev.*, 66 Fed. (2d) 45, (C. C. A. 4, 1933);
McGuire v. *Commissioner*, 84 Fed. (2d) 431 (C. C. A. 7, 1936).

The First and Second Circuits and in other cases the Seventh Circuit, however, have held to the contrary, holding that in order to make paragraph (g) of Section 115 applicable, the cancellation must be part of a scheme to avoid the distribution of taxable dividends.

Commissioner v. *Brown*, 69 Fed. (2d) 602, 603, 604 (C. C. A. 7, 1934);
Commissioner v. *Rockwood*, 82 Fed. (2d) 359, 361 (C. C. A. 7, 1936);
Commissioner v. *Cordingley*, 78 Fed. (2d) 118, 120 (C. C. A. 1, 1935);
Commissioner v. *Quackenbos*, 78 Fed. (2d) 156, 158 (C. C. A. 2, 1935);
Patty v. *Helvering*, 98 Fed. (2d) 717, 719 (C. C. A. 2, 1938).

The Circuit Court of Appeals of the Second Circuit, in the last case cited, referring to the conflict in the Circuits, stated at p. 719 as follows:

". . . We shall continue to follow *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156, until the Supreme Court makes authoritative a different interpretation."

In view of the conflict in the Circuits and the recognition of the conflict by the various Circuit Courts of Appeal, it is submitted that this Court should resolve the conflict and settle the proper interpretation to be given to paragraph (g) of Section 115.

III

The Court below has decided an important question of Federal law which has never been, but should be, settled by this Court, to-wit: whether paragraph (g) of Section 115 of the Revenue Act of 1934, or its predecessors beginning in 1926 and its successors, are applicable to distributions made pursuant to cancellations of *stock not originally issued as a stock dividend*, where the cancellations occurred prior to January 1, 1926. The Court below held paragraph (g) of Section 115 applicable to the transaction in the case at bar, although the cancellation of stock not originally issued as a stock dividend occurred in 1914, long before January 1, 1926.

Prior to January 1, 1926, paragraph (g) of Section 115 (then Section 201) and its predecessors were applicable only to a cancellation or redemption of stock previously issued as a stock dividend. The Section was amended in the Revenue Act of 1926 to include cases where stock not issued as a stock dividend was redeemed or canceled, but the following exception was added:

"In the case of a cancellation or redemption of stock not issued as a stock dividend, this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926."

This exclusion was intentional as is seen from the Congressional Committee Reports. *Sen. Rep. 52, 69th Cong., 1st Sess. p. 15; House Rep. 356, 69th Cong. 1st Sess. p. 30.*[1]

The same language is carried in subsequent revenue acts up until the Revenue Act of 1932, where Congress felt that the same intention was taken care of by other language in the Act. *Vol. 2, House Rep., 72nd Cong. 1st Sess. Rep. No. 708, p. 31.*[2] The Revenue Act of 1934 followed the same scheme as that of 1932. *House Rep. 73rd Cong. 2nd Sess. Vol. 2, Rep. No. 704, p. 20; Sen. Rep. 73rd Cong. 1st and 2nd Sess. Vol. 1, Rep. No. 558, p. 21.*[3]

This highly important question of interpretation of the Revenue Acts of 1926 and thereafter has not been decided by this or any other court, to our knowledge.

IV

The decision of the Circuit Court of Appeals below is in conflict with the decision of another Court of Appeals and the Board of Tax Appeals on another question. Fur-

---

[1] The exclusion was not in the original House Bill but was added by the Senate. *Senate Rep. 52, p. 15, 69th Cong. 1st Sess.* In Conference the House receded and in the House Conference Committee report, *House Rep. 356, p. 30, 69th Cong., 1st Sess.*, we find with reference to Section 201(g):

> "This Amendment provides that in the case of cancellation or redemption of stock not issued as a stock dividend, this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926, and the House recedes."

[2] "Under the existing law the provisions of Section 115(g) were made applicable in the case of the cancellation and redemption of stock not issued as a dividend, only if the cancellation or redemption was made after January 1, 1926.

"This provision was inserted to prevent Section 115(g) being retroactive. It is, however, no longer necessary, because the proposed income tax title applies only to 1932 and subsequent years."

[3] The first section of the Revenue Act of 1934 says:

> "The provisions of this title apply only to taxable years beginning after December 31, 1933."

This was interpreted by the House and Senate committees in the same manner as the analogous provision in the 1932 act. The committee reports say:

> "The Bill follows the general plan and arrangement of the Revenue Act of 1932. The income tax title is made applicable to taxable years beginning after December 31, 1933."

ther, such decision decided an important question of federal law which has not been, but should be, expressly settled by this Court, although, to be sure, such decision was in conflict with the principle announced in an analogous decision of this Court not passing upon the point directly. Both the District Court and the Circuit Court of Appeals below were of the opinion that a winding up of a business must be contemplated, or at least a policy of contraction manifested in order to have a "partial liquidation" under paragraph (i) of Section 115 of the Revenue Act of 1934. The Circuit Court of Appeals below recognized that this was not the rule according to the decision of another Circuit (R. 101).

In *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156, 157 (C. C. A. 2, 1935), the Court of Appeals of the Second Circuit said:

> "A redemption of part of the stock of a corporation whether it be all of a class such as of preferred stock, or of a part of the common stock, has no necessary relation to the winding up of a corporation."

The Board of Tax Appeals also expressly held to the same effect in *Salt Lake Hardware Co.* v. *Commissioner*, 27 B. T. A. 482 at 486.

Even without the decisions of the Board of Tax Appeals and the Second Circuit, it would appear to be clear that the definition given in paragraph (i) of Section 115 makes "a distribution in partial liquidation" *words of art* for the purposes of Section 115. This was inferentially recognized by this Court in *Foster* v. *U. S.*, 303 U. S. 118, 121, 58 S. Ct. 424, 82 L. Ed. 700 (1938). The facts in that case as shown by the findings of the Court of Claims, *17 Fed. Supp. 191, 192*, were that the corporation there continued to make handsome profits, paid large dividends, manifested no policy of contraction, and had no idea of winding up the busi-

ness when it redeemed a portion of its stock. Yet this Court held that the redemption of stock and distribution in that case was a partial liquidation, properly chargeable to capital account under subsections (c) and (h) (now subsection [i]) of Section 115 (303 U. S. 121).

We believe the Court should decide whether subsection (i) of Section 115 of the Revenue Act of 1934, and analogous sections in previous and subsequent acts gives a special meaning to "a distribution in partial liquidation" as therein defined, or whether popular conceptions of liquidation override the congressional definition.

V

The Circuit Court of Appeals decided another Federal question in a way probably in conflict with applicable decisions of this Court. The decisions below held that since the corporation had on hand sufficient accumulated earnings since February 28, 1913, from which to have made the distributions in the cases at bar, such distributions of the par value of stock previously canceled by the corporation upon a reduction of its authorized and paid-up capital, were not properly chargeable to capital account nor non-taxable under subsections (i) and (c) of Section 115 of the Revenue Act of 1934, but were taxable as dividends under subsections (a) and (b) of that Section.

This Court in *Jerome* v. *Cogswell*, 204 U. S. 1, 51 L. Ed. 343, 27 S. Ct. 241 (1907), held that where the unimpaired capital of a corporation is reduced and par value stock canceled, the corporation owes the par value of the canceled stock as a debt to the shareholders whose stock is canceled.[4]

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[4] To like effect see *Seeley* v. *N. Y. Nat. Exch. Bank of N. Y.*, 8 Daly (N. Y.) 400, Aff. 78 N. Y. 608 (1879); *Roberts* v. *Roberts-Wicks*, 92 N. Y. S. 387, 102 App. Div. 118 (1905); *In Re Artisans Land & Mort. Corp.*, 1904 L. R. 1 Chancery 796; *Thompson on Corporations*, 3rd Ed. Vol. 5, Sec. 3695; *Fletcher's Cyclopoedia of the Law of Corporations*, Vol. 11, Sec. 5150; *Morawetz on the Law of Private Corporations*, 2d Ed. Vol. 1, Sec. 443.

Similarly in the cases at bar the corporation owed a debt to the stockholders whose stock was canceled in 1914. When this debt was paid in 1934, by the distribution in question, it was necessarily a return of capital and properly chargeable to capital account.

In *Foster* v. *U. S.*, 303 U. S. 118, 121, 58 S. Ct. 424, 82 L. Ed. 700 (1938), this Court likewise held that a distribution in cancellation of part of an issue of stock was properly chargeable to capital account under subsections (c) and (h) (now [i]) of Section 115. The decisions below were directly contrary to the *Jerome* and *Foster* cases decided by this Court.

To hold that the distribution here be not considered a return of capital but dividends, requires Mrs. Rheinstrom to make a *nunc pro tunc* gift of $36,600 to Karl Kiefer. The preferred stock in the cases at bar had no limitation as to its right to share in the surplus on final liquidation, and therefore under *Continental Ins. Co. et al.* v. *U. S. et al.*, 259 U. S. 156, 181, 66 L. Ed. 871, 888, 42 S. Ct. 540 (1922), had equal right per par value with the common stock to share in the surplus upon liquidation. Because of this, by the reduction in the common stock without reduction in the outstanding preferred stock, which was all held by Karl Keifer, Mrs. Rheinstrom's proportionate ownership in the corporation was reduced approximately from two-fifths to one-fifth, and Karl Kiefer's proportionate ownership was increased from approximately three-fifths to four-fifths. (See calculation on page 23 of appellant's brief in the Court of Appeals, part of Appendix B to this petition.) This is conceded by the Circuit Court of Appeals (R. 105).

The Circuit Court of Appeals, in spite of the foregoing, and the decision of this Court in *Koshland* v. *Helvering*, 298 U. S. 441, 80 L. Ed. 1268, 56 S. Ct. 767 (1936), con-

sidered the proportionate stock ownership of the corporation virtually untouched, citing *Eisner* v. *Macomber,* 252 U. S. 189 (R. 103), which case is inapplicable on the point, because of the preferred stock factor in the cases at bar.

Thus the decision below deprived Mrs. Rheinstrom of her right to receive one-half of the $122,000 surplus created by the reduction of capital, which *Jerome* v. *Cogswell, supra,* says was a debt due her, but instead entitled her to receive only one-fifth thereof, a difference of $36,600, which under *Continental Ins. Co. et al.* v. *U. S. et al., supra,* will accrue to Karl Kiefer. Surely such a *nunc pro tunc* gift cannot be forced upon Mrs. Rheinstrom within due process of law.

VI

The Circuit Court of Appeals has sanctioned such a departure by the District Court from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision. The petitioners in the trial court sought to introduce evidence from the director and stockholder who proposed the resolutions reducing the capital in 1914, that the purpose of the reduction was to create a surplus due the stockholders which they could draw down at any time at their election so as to have money available to make outside investments if they so desired (R. 31-33). This testimony clearly showed that it was the intention of the parties involved to have the surplus created by the reduction of capital belong to the stockholders whose stock was canceled. No tax saving could have been effected at the time and the Government has never even suggested any purpose for the reduction other than that brought out by the proposed testimony. Such testimony tended to show that the stockholders intended in fact what *Jerome* v. *Cogswell, supra,* requires as a matter of law. The District Court rejected the testimony on the ground of the parol evidence rule (R. 30, 31, 41).

This was contrary to the rule in Ohio, which governs the cases here, and which merely follows the general rule, that the bar of the parol evidence rule cannot be raised by anyone who is not a party to the transaction even if that person be a Tax Collector.

Bowman v. *Tax Com. et al.*, 135 O. S. 295, 16 N. E. (2d) 459 (1939), approving *Platt* v. *Huron Co. Banking Co.*, 50 O. S. 528, 35 N. E. 308 (1893). See also *Jones' Commentaries on Evidence*, 2nd Ed. Sec. 1488.

Furthermore, corporate resolutions, since they are not of a contractual nature and do not define rights, are not the kind of instruments to which the parol evidence rule applies.

Lawrence v. *Premier Indemnity Ins. Co. et al.*, 180 Cal. 688, 182 Pac. 431 (1919);
Daggett v. *St. Paul Tropical Development Co.*, 141 Minn. 51, 169 N. W. 252 (1918);
Cook v. *Manasquan*, 80 N. J. L. 206, 76 A. 310 (1910);
Butts v. *Gaylord State Bank*, 156 Misc. 555, 282 N. Y. S. 1 (1935).

Also, even if the parol evidence rule were otherwise applicable, it would not prohibit evidence of purpose.

Bowman v. *Tax Com. et al.*, 135 O. S. 295, 16 N. E. (2d) 459 (1939);
Third Nat. Bank v. *Laidlaw*, 86 O. S. 91, 100, 98 N. E. 1015 (1912);
Merchants Nat. Bank v. *Cole*, 83 O. S. 50, 93 N. E. 465 (1910);
Morgan v. *Boyer*, 39 O. S. 324 (1883).

This is also the rule of this Court, *Brick* v. *Brick*, 98 U. S. 514, 25 L. Ed. 256 (1878).

In its opinion the trial court adhered to its exclusion of the evidence, but stated that it would not have been persuaded by it even if admitted (R. 62-63). The Circuit Court of Appeals held that if the exclusion was error, it was

harmless because the trial court had thus considered it in its findings, and because counsel for petitioners stated that the evidence showed the stockholders intended only what followed as a matter of law.

It is submitted that the citations above clearly show that the exclusion was error. Surely, exclusion of such important evidence is not rendered harmless merely because it shows the stockholders intended their rights to be what *Jerome* v. *Cogswell* held them to be as a matter of law, nor because the trial court, to excuse its error, says that it would not have been persuaded by the testimony even had it been admitted.

Is not the proper criterion of prejudice, whether such testimony is calculated to have a material effect on the decision of any reasonable court or jury, not whether a particular Judge considered it persuasive on his own mind?

This Court has never decided whether the parol evidence rule can be raised by the Government in a tax case. Also, it should not permit the error of exclusion of such vital evidence as in the cases at bar to be considered harmless.

VII

The Circuit Court of Appeals has decided another important question of Federal law which has never been, but should be, settled by this Court, to-wit: does it violate due process of law and the apportionment of requirements of *Art. 1, Sec. 2, Clause 3,* and *Section 9, Clause 4 of the Federal Constitution*[5] to cast the burden of an income tax on dividends upon remaindermen under a trust who are not

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[5] Article I, Section 2, Clause 3, reads in part:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . . ."

Article I, Section 9, Clause 4, reads:

"No Capitation, or other direct Tax shall be laid, unless in Proportion to the Census or Enumeration hereinbefore directed to be taken."

entitled to receive dividends, but entitled to receive capital only? Under the will of Karl Kiefer, deceased, the petitioner bank, as trustee, was to hold one-third of his estate in trust, paying the income thereon for life to Adele Kiefer, and upon her death to pay the principal to designated remaindermen (R. 84). Upon this one-third of the Kiefer portion of the distribution, the petitioner bank, as trustee, was required to pay the income tax in dispute in this case.

Under the terms of the trust, if the distribution was income, the life tenant was entitled to the same, and the life tenant, not the trustee, is required to pay the income tax thereon, whether or not the life tenant actually received the distribution. *Freuler* v. *Helvering*, 291 U. S. 35, 78 L. Ed. 634, 54 S. Ct. 308 (1934).

The Commissioner of Internal Revenue, however, held that the tax was not payable by the life tenant (R. 59-60, 87). Instead the respondent required the trustee bank to pay the income tax on the distribution although the trustee held the same as principal under the will (R. 85). The effect of all this was to charge the remaindermen who are not entitled to receive any income but only entitled to receive principal with a tax on a distribution which can be upheld only if it is income. In other words, if the distribution was income the life tenant should have paid the tax; if it was principal, it is properly chargeable to capital account and not taxable at all. Can the interest of the remaindermen entitled to capital only thus be charged with a tax on income? Does not such action violate due process of law?

Furthermore, if the distribution is capital, *Art. I, Section 2, Clause 3*, and *Section 9, Clause 4*, of the Federal Constitution is violated, because the tax is not apportioned among the several states in accordance with population.

Wherefore, your petitioners respectfully pray that writs of certiorari be issued out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Sixth Circuit commanding that Court to certify and send to this Court for its review and determination on a day certain to be named therein, a transcript of the record and proceedings in both cases herein, and that the judgments of said United States Circuit Court of Appeals for the Sixth Circuit in both cases herein may be reversed by this Honorable Court, and that your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

Respectfully submitted,

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APPENDIX A

REVENUE ACT OF 1934

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203(a)(4) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117(a), 100 per centum of the gain so recognized shall be taken into account in computing net income. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) *Other distributions from capital.*—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not

out of earnings or profits, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

(e) *Distributions by personal service corporations.*—Any distribution made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921, shall be exempt from tax to the distributees.

(f) *Stock dividends.*—A stock dividend shall not be subject to tax.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Distribution of stock on reorganization—Effect on distributions.*—The distribution before January 1, 1934, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of the section for the purpose of determining the taxability of subsequent distributions by the corporation. As used in this subsection, the terms "reorganization" and "party to the reorganization" shall have the meanings assigned to such terms in section 112 of the Revenue Act of 1932.

(i) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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(9)

IN THE

Supreme Court of the United States

OCTOBER TERM 1942

No. 239

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

No. 240

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

APPENDIX B
TO ACCOMPANY PETITION FOR WRITS OF CERTIORARI. BRIEFS FILED IN CIRCUIT COURT OF APPEALS

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Nos. 8850 and 8851

United States Circuit Court of Appeals

For the Sixth Circuit

JAMES A. RHEINSTROM, Executor under the Will of MINNA W. RHEINSTROM, deceased,

Appellant,

vs.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee,

and

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of KARL KIEFER, deceased,

Appellant,

vs.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

BRIEF FOR THE APPELLANTS

On Appeal from the District Court of the United States for the Southern District of Ohio, Western Division.

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United States Circuit Court of Appeals

For the Sixth Circuit.

Nos. 8850 and 8851

JAMES A. RHEINSTROM, Executor under the Will of MINNA W. RHEINSTROM, deceased,

Appellant,

vs.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee,

and

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of KARL KIEFER, deceased,

Appellant,

vs.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF OHIO, WESTERN DIVISION.

BRIEF FOR THE APPELLANTS

THE CASE BELOW.

Appellants are taxpayers and sued appellee below to recover back income taxes paid for the calendar year 1934 on

their proportionate shares of a fund of $122,000.00 paid out by the Karl Kiefer Machine Co. during that year. The cases were tried without a jury before the Hon. John H. Druffel, District Judge, who gave judgment to appellee in both cases and rendered an opinion which will be found in the record, R. 60-67, and which is reported in 33 F. Supp. 917 (1940). The cases were considered together below, and to save repetition will be presented together in this Court.

QUESTION PRESENTED.

Whether the fund of $122,000 paid by The Karl Kiefer Machine Company to appellants and other stockholders in 1934 represented a return of capital not taxable under the Sixteenth Amendment to the Constitution of the United States and tax free under the provisions of Section 115 (c), (d), and (i) of the Revenue Act of 1934, or constituted income within the meaning of that Amendment and taxable as such under the provisions of Section 115 (a) and (b) of that Act.

STATUTES INVOLVED.

The statutes involved will be found in the Appendix, infra, pp. 39, 40, 41 and 42.

STATEMENT OF FACTS.

The Karl Kiefer Machine Company is a corporation organized in the year 1908 under the laws of the state of Ohio (R. 14). At the time the company was organized it had an authorized capital of $500,000, of which $300,000 consisted of 3000 shares of common stock of a par value of $100.00 per share, and $200,000 consisted of 2000 shares

of preferred stock of a par value of $100.00 per share (R. 14). From the date of the organization of the company and until November 30, 1914, 1500 shares of the common stock and 420 shares of the preferred stock were fully paid up, issued and outstanding (R. 15).

Prior to November 30, 1914, Minna W. Rheinstrom was the beneficial owner of 750 shares of the outstanding common stock of the company (R. 15), while Karl Kiefer was the beneficial owner of the remaining 750 shares of the outstanding common stock and all of the outstanding shares of preferred stock, 420 shares, of the company (R. 43, Pl. Ex. 10).

On November 28, 1914, at a special meeting of the stockholders of the company, at which all its outstanding stock was represented, it was unanimously agreed that the capital stock should be reduced from $500,000 to $70,000, to consist of $42,000 preferred stock divided into 420 shares at $100 each, and $28,000 common stock divided into 280 shares at $100 each (R. 15), and the president of the company was authorized to take the necessary action to make the reduction effective (R. 15). On November 30, 1914, the board of directors of the company approved the action of the stockholders and likewise authorized the president to take the necessary steps to bring about the reduction (R. 16). Thereafter a certificate of reduction of capital stock was filed in the office of the Secretary of State, Columbus, Ohio, and on December 1, 1914, that officer issued his certificate showing that the reduction of the capital stock of the company had been made and recorded in his office (R. 17, 18).

Upon the filing of the certificate of reduction of capital stock, certificates representing 1496 shares of common stock of the Karl Kiefer Machine Co. including 748 shares each owned by Minna W. Rheinstrom and Karl Kiefer,

were delivered to the company and cancelled; new certificates for 276 shares of common stock of the par value of $100.00 each were issued by the company, certificates for 138 shares thereof being issued to Mrs. Rheinstrom, and a like number to Karl Kiefer (R. 18). The remaining four shares of the 280 shares of reduced common stock were beneficially owned, two shares each, by Mrs. Rheinstrom and Karl Kiefer, but were in the name of other persons to qualify them as directors. Thus Mrs. Rheinstrom and Karl Kiefer each was the beneficial owner of one-half of the common stock both before and after the reduction of capital, each returning a net of 610 shares of common stock for cancellation to the corporation. Karl Kiefer owned the entire outstanding preferred stock, namely 420 shares both before and after the reduction in capital (R. 83).

The minutes of the meetings of the stockholders and directors of the Karl Kiefer Machine Company which record the action by which the reduction of its capital stock was accomplished are silent as to the motive which led to the taking of this action (R. 15, 16). They do record, however, that at the meeting of the stockholders and also at the meeting of the board of directors the motion to have the stock reduced was made by James A. Rheinstrom, a stockholder and secretary of the company (R. 15, 16).

Karl Kiefer died on April 16, 1931, and under the provisions of his will, appellant, the First National Bank as Trustee was left one-third of his estate in trust to pay the income thereof to Adele Kiefer for life, and on her death to pay the principal to designated remaindermen (R. 84).

In 1934 in addition to paying to its stockholders as declared dividends from earnings on common stock the sum of $90,000.00, the Karl Kiefer Machine Co. paid to

Mrs. Rheinstrom and to the legatees of Karl Kiefer the sum of $122,000.00, which it considered was in re-payment for the cancellation of the 1220 shares of common stock (Pl. Exs. 5, 6-A, 6-B, 7), of which $61,000.00, representing the 610 shares of her $100.00 par value common stock which had been cancelled, was paid to Mrs. Rheinstrom, and $20,333.33 or one-third of the $61,000.00 due Karl Kiefer for his 610 shares of similar stock, was paid to the bank as trustee under the will of Karl Kiefer (R. 14, 84-5).

When Minna W. Rheinstrom and the trustee bank received the sum of $61,000.00 and $20,333.33 respectively from the Karl Kiefer Machine Co. in 1934, they did not regard it as income; on the contrary they considered it as return of capital, that is, repayment by the company of the capital which had been used to purchase the common stock which they had owned and surrendered in 1914 pursuant to the resolutions heretofore referred to (R. 14-18, R. 80-85). Thereafter, however, appellee required them to file amended returns so as to include those sums as income for the year 1934 (R. 14, 85). It is with respect to the legality of this action under Section 115 of the Revenue Act of 1934 that these cases arise.

STATEMENT OF POINTS TO BE URGED.

I. When Mrs. Rheinstrom and Karl Kiefer each surrendered 610 shares of their common stock of the par value of $100 each to The Karl Kiefer Machine Company in 1914, and they were cancelled by the company, it was expressly understood by all the parties concerned that the company would repay the shareholders, upon demand, the paid-in surplus created by the reduction of the capital stock; and the payment of the $122,000 in 1934

by the company was to discharge the obligation created by the surrender of the stock and, therefore, was a return of capital not taxable under the Sixteenth Amendment to the Constitution of the United States and the provisions of Section 115 of the Revenue Act of 1934, passed pursuant thereto.

A. The Court Erred in Rejecting Parol Evidence of such understanding.

II. Without regard to any express understanding between The Karl Kiefer Machine Company and its stockholders, by operation of law the company became obligated in 1914 to repay to the stockholders *pro rata* the paid-in surplus created by the surrender and cancellation of the 1220 shares of common stock of the par value of $100 each; and the payment of the $122,000 to discharge this obligation, constituted a return of capital and as such was not subject to income taxation under the Sixteenth Amendment to the Constitution of the United States and the provisions of Section 115 of the Revenue Act of 1934, passed pursuant thereto.

III. The payment of the $122,000 was for the cancellation of 1220 shares of common stock, and was a distribution in partial liquidation as defined by the Section 115 of the Revenue Act of 1934. It was properly chargeable to capital account and was made free from the imposition of income tax by that very section of the act.

I.

The Distribution by a Corporation of the Surplus Created by the Surrender by a Shareholder of his Shares of Stock for Cancellation, Pursuant to an Express Agreement, is a Return of Capital and not an Income Producing Transaction.

When, in 1914, Mrs. Rheinstrom and Karl Kiefer each surrendered 610 shares of common stock of The Karl Kiefer Machine Company for cancellation and thereafter the company, pursuant to corporate action approved by the Secretary of State of Ohio, cancelled such shares without at that time repaying their par value, some purpose must have been intended. It is appellant's contention that the actual understanding between the company and the stockholders in 1914 was that the company should repay to the stockholders the capital which had been paid in for the 1220 shares of stock whenever they should make a demand for payment, and that the payment made in 1934 was in fulfillment of this obligation.

Although the minutes and records of the company unequivocally show that the capital stock of the company was reduced, that 1220 shares of fully paid-up common stock were returned to the company and cancelled (R. 18), and that a paid-in surplus was thereby created, they do not show the purpose for which this corporate action was taken (R. 15, 16). Fortunately, the appellant was able to produce at the trial of this case in the District Court a witness who had personal knowledge of the motive which inducted the stockholders to surrender their stock in 1914 and of the intention of the company to repay the capital which the shares represented in their hands (R. 28). That witness was James A. Rheinstrom,

the only surviving stockholder and director of the company, who in 1914 was secretary of the company, was present at the stockholders' and directors' meeting at which the resolutions calling for the reduction of the capital stock of the company were adopted, and who in fact moved the adoption of those resolutions (R. 15, 16). Mr. Rheinstrom was thus in a position to testify from his own observation and recollection as to the understanding between the company and its shareholders which culminated in the events referred to.

However, when Mr. Rheinstrom took the witness stand and was asked to state the facts which prompted the adoption of the resolutions leading to the reduction of the capital stock of the company and the purpose of such reduction, the District Court, upon objection by counsel for the appellee, refused to permit him to answer on the ground that the testimony he was about to give would, if received, violate the parol evidence rule (R. 30). Although counsel for the appellant pointed out to the Court that the grounds upon which the objection was based were not well taken (R. 30), the Court nevertheless adhered to its view that the testimony offered was inadmissible and sustained the appellee's objection, thus excluding the testimony of the only living person who had personal knowledge of the facts upon which the single issue of the case depends.

A. The Court Erred in Rejecting Parol Evidence of such Understanding.

The action of the District Court in refusing to permit Mr. Rheinstrom to testify was, it is submitted, erroneous on at least three grounds. (1) The Parol Evidence Rule can be taken advantage of only by the parties to an

instrument and their privies, but it is of no avail to third parties as the appellee here. (2) Corporate minutes do not constitute the type of instrument to which the Parol Evidence Rule applies. (3) The Parol Evidence Rule does not exclude testimony of the background or purpose of the parties in executing an instrument.

Rule 43 (a) of the Rules of Civil Procedure for the District Courts of the United States provides in part as follows:

> " * * * All evidence shall be admitted which is admissible under the statutes of the United States, or under the rules of evidence heretofore applied in the courts of the United States on the hearing of suits in equity, or under the rules of evidence applied in the courts of general jurisdiction of the state in which the United States court is held. In any case, the statute or rule which favors the reception of the evidence governs and the evidence shall be presented according to the most convenient method prescribed in any of the statutes or rules to which reference is herein made."

The cast of subdivision (a) of Rule 43 is obviously toward admissibility, not exclusion, *Moore's Federal Practice Under the New Federal Rules,* Section 43.02 (1938), and when a point of admissibility is raised, if the evidence is admissible under the rules of evidence applied in the courts of general jurisdiction of the state in which the federal court is held, the evidence should be admitted. It is only when the law of that state is opposed to admissibility that other sources of authority should be sought.

But if, notwithstanding the clear language of Rule 43 (a), any doubt had remained about the matter, it is dispelled by the decision of the Supreme Court of the

United States in *Erie R. R. Co.* v. *Tompkins*, 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188 (1938), overruling *Swift* v. *Tyson*, 16 Peters 1, 10 L. Ed. 865 (1842), in which it was held that the local state law must be followed when the problem before the court is not governed by federal statute. It follows, therefore, both by the decision of the Supreme Court and the unambiguous language of Rule 43 (a) that where the testimony sought to be adduced is admissible under the law of the state in which the federal court is held, it should be admitted by that court.

(1) Under the law of Ohio, the testimony which the appellant sought to introduce is admissible. In *Platt* v. *Huron County Banking Company*, 50 Oh. St. 528, 35 N. E. 308 (1893), the court said:

> "As a general rule, it is not competent to vary the terms of a written instrument by parol testimony. But this applies only to controversies between the parties to the instrument and their privies. In a suit between third persons, strangers to the instrument, or between a party to the instrument and a stranger, such evidence is admissible."

See also *Jones, Commentaries on Evidence*, 2d Edition, §1488, where it is said:

> "The parol evidence rule is limited to the parties to the contract or writing or their privies. Therefore when the controversy is between a party to a written contract and one who is neither a party nor a privy to it, the rule which the courts usually refer to as 'excluding parol evidence tending to vary, modify or contradict the writing' does not apply."

Neither the appellee nor the United States was a party to the action taken by the stockholders and directors of

The Karl Kiefer Machine Company in 1914 and, therefore, it is submitted that, even if the parol evidence rule were otherwise applicable in this case, as third parties to the transaction, they could have no valid ground of objection on that score.

In a situation which closely parallels that at bar, the Supreme Court of Ohio, in *Bowman* v. *Tax Commission, et al.*, 135 Oh. St. 295, 16 N. E. (2d) 459 (1939), reaffirmed the rule of the *Platt* case. There the Tax Commission of Ohio had objected to the admission of parol testimony relating to the character, form and operation of certain insurance contracts. In holding the evidence admissible, the Court said:

> "While parol evidence may not be received to contradict or vary the terms of a written instrument as between the parties thereto and those claiming under them, such evidence is admissible when otherwise competent in controversies between strangers to the instrument, or between a stranger and a party thereto."

(2) However, even though it be assumed that the appellee was a party to the transaction, which clearly he was not, there is authority for the proposition that the testimony offered would not have been offensive to the parol evidence rule, since the minutes of the stockholders' and directors' meetings are not the kind of writings toward which that rule is directed. In order for a writing to come within the operation of the rule governing the admission of extrinsic evidence it must be of a contractual nature or definitive of the rights of the parties. 17 O. Jur. 565, Sec. 458. The minutes in this case are neither contractual nor definitive of such rights; they are merely a summary record of what transpired at the

meetings of the stockholders and directors,—a short and simple account of ultimate facts.

On this point, *Lawrence* v. *Premier Indemnity Insurance Company, et al.*, 180 Cal. 688, 182 Pacific 431 (1919), is strikingly apposite. In that case, for the purpose of showing plaintiff's ownership of stock, there were introduced on his behalf, among other things, the minutes of a stockholders' meeting. The defendant offered parol testimony contra to the effect that the minutes did not show the real transaction and understanding, and that the stock was to be the plaintiff's only on certain conditions. The plaintiff objected on the ground that such testimony was incompetent under the parol evidence rule as varying the terms of the written insrtument, to-wit, the minutes of the meeting. The Supreme Court of California held this objection not well taken, saying:

> "Plaintiff's counsel contend that testimony showing that something took place at the meeting other than is shown by the minutes is not admissible under the 'parol evidence' rule. But minutes of a meeting are not a written instrument. Their function is merely to act as a written record of what took place at the meeting. That record may be true or it may not be, and in the absence of the element of estoppel, it is permitted to the corporation or to anyone else to show what actually did take place at the meeting."

See also, *Daggett* v. *St. Paul Tropical Development Company*, 141 Minnesota 51, 169 N. W. 252 (1918); *Cook* v. *Manasquan*, 80 N. J. L. 206, 76 Atl. 310 (1910), *Butts* v. *Gaylord State Bank*, 156 Misc. 555, 282 N. Y. S. 1 (1935).

(3) Apart from authority, however, it is submitted upon sound legal principles, that the testimony of Mr. Rheinstrom should have been admitted. As the proffer made

at the trial shows (R. 31-33), his testimony would have disclosed the purpose of the action of the stockholders and directors of The Karl Kiefer Machine Company in reducing the capital stock and in the return and cancellation of the 1220 outstanding shares of common stock. There was nothing in the testimony he was about to give which would have even remotely tended to contradict or vary the tenor of the minutes for the reason that they contain nothing whatever to denote the underlying purpose of the transaction. On the contrary, the need for his testimony was imperative since without it there was no way in which the decisive facts upon which the issue of the case depends could be ascertained.

It is a general rule, not only in Ohio, but elsewhere, that the surrounding circumstances leading up to the execution of any written instrument, and particularly the purpose of the parties in executing such instrument, may be shown by extrinsic parol evidence. Thus, in *Third National Bank* v. *Laidlaw*, 86 Oh. St. 91, 100, 98 N. E. 1015 (1912), the Court said:

> " • • • evidence of the surrounding circumstances is competent in order to arrive at the intention of the parties."

See also *Merchants National Bank* v. *Cole*, 83 Oh. St. 50, 93 N. E. 465 (1910); *Morgan* v. *Boyer*, 39 Oh. St. 324, 48 Am. Rep. 454 (1883); and *Rorick* v. *Gilbert*, 45 Oh. App. 96, 186 N. E. 756 (1931). This principle was also confirmed in the *Bowman* case, *supra*, by the Supreme Court of Ohio, and by the Supreme Court of the United States in *Brick* v. *Brick*, 98 U. S. 514, 25 L. Ed. 256 (1878), where it was said that

> "The rule which excludes parol testimony to contradict or vary a written instrument has reference to the language used by the parties. • • •

> The rule does not forbid an inquiry into the object of the parties in executing and receiving the instrument."

When the District Court sustained the objection to the testimony which Mr. Rheinstrom was about to give, counsel for the appellant thereupon made a proffer as to what he would have said (R. 31), had he been allowed to testify. As indicated in the record (R. 31, 32, 40, 41), his testimony would have shown that it was the understanding of all the parties to the reduction of the capital stock of The Karl Kiefer Machine Company that the capital which had been used by the stockholders to pay for the shares for which they had subscribed, to-wit, $100 per share, should be repaid to them at any time demand for repayment was made. When, therefore, in 1934, the company paid out the $122,000, which it had expressly agreed to repay by reason of the surrender and cancellation of the 1220 shares, Mrs. Rheinstrom and the legatee of Karl Kiefer received merely a return of the original capital investment, an amount equal to that originally paid in for the cancelled shares. Thus, the entire transaction was a capital transaction from which they realized no income upon which a tax could be imposed by the Revenue Act of 1934, within the limitations of the Sixteenth Amendment, or was intended to be imposed by that Act.

II.

When a Shareholder Surrenders Shares of Capital Stock to a Corporation for Cancellation, the Corporation, if its Capital is Unimpaired, Becomes Obligated as a Matter of Law, to Repay to such Shareholder the Paid-In Capital Which the Shares Represent and Which is Made Free by the Cancellation.

The appellant further contends that even in the absence of an express understanding between the parties that The Karl Kiefer Machine Company was to repay an amount equal to the par value of the common stock surrendered by Mrs. Rheinstrom and Karl Kiefer for cancellation, the duty to repay that amount was created by operation of law in 1914 when the surrender and cancellation occurred. It is a general rule of the law of corporations that the price paid by the subscribers to the capital stock of the corporation for their shares belongs to the corporation and that the certificate of stock issued to the stockholders merely evidences their right, *inter alia,* to participate in the distribution of its earnings, if, as, and when dividends are declared by the board of directors, and to share *pro rata* in the distribution of the assets of the corporation when its affairs are wound up. In other words, a stockholder has no interest in the assets *eo nomine* of the corporation. When, however, a corporation whose capital is unimpaired determines to liquidate in whole or in part, its relationship to its stockholders with respect to its assets undergoes a change. In the absence of creditors, a corporation, in accordance with its by-laws, and with the approval of the Secretary of State, may redeem all or a part of its shares, and pay for them by a distribution of its assets, either in cash or in property; and the

redemption and cancellation of the shares of stock of any stockholder, when the corporation does not pay the redemption price at once, *ipso facto* creates a debt in favor of the stockholder, and his relationship to the company is thereby transformed from stockholder to creditor.

That such a change in the legal position of a stockholder occurs upon the reduction of the capital stock of a corporation, in whole or in part, when the stockholder surrenders his stock for cancellation and is not thereupon repaid the equivalent of its par value, is uniformly recognized by the courts. A leading case on this subject is *Jerome* v. *Cogswell*, 204 U. S. 1, 27 S. Ct. 236, 51 L. Ed. 345 (1907). In that case the directors of a national bank having a capital stock of $300,000, by appropriate action of the stockholders and directors, reduced its capital to $200,000. The stockholders thereupon surrendered their certificates representing the shares of the original capital in return for two-thirds of the number of shares originally held. Some years later, when the charter of the bank expired, and while its affairs were being wound up in the manner provided by law, a question arose as to whether the proceeds of the surplus of assets resulting from the reduction of the capital and cancellation of the excess shares of stock should be distributed to the stockholders of record at the time the reduction was made, or at the time the charter expired. The stockholders of record at the time the reduction was made, who had in the meantime transferred their shares, claimed that they had a right to share in the surplus created by the reduction of the capital, that they became creditors of the corporation to that extent upon the reduction, and that this surplus was not part of the corporation's assets to be divided among the persons who happened to be shareholders at the time of the dissolution.

The Supreme Court of the United States held in favor of the stockholders of record at the time of the reduction of the capital stock occurred, and thereby declared the law by which the case at bar is governed. It said (at page 7):

> "As a general rule it may be admitted that where capital stock is impaired and a reduction is made merely to meet that impairment, there can be no distribution. But that is not this case, in which the stockholders of record June 9, 1900 (the date when the capital was reduced), *had a right to require a distribution among them of an excess upon reduction in proportion to their respective holdings.* In the language of the Connecticut Supreme Court: 'The right to receive what might ultimately be realized from the fund thus set apart became therefore irrevocably vested in those who were stockholders on June 9, 1900, and they or their assigns are now entitled to whatever is to be distributed from it'." (Matter in parenthesis and italics added.)

The validity of the appellant's assertion that Mrs. Rheinstrom, upon the surrender and cancellation of her stock, ceased to be a stockholder to that extent and became a creditor of The Karl Kiefer Machine Company to the extent of the par value of the stock cancelled, is further strengthened by the holding of the Supreme Court that the right to receive payment for the shares cancelled vests irrevocably in the shareholder of record at the date of the cancellation, and is not affected by the fact that thereafter the shareholder transfers his shares to a third party. On this point the Court said (at page 8):

> "It follows as held that the transfer of shares after the reduction of June 9, 1900, did not carry any right to an interest in the special trust fund, the proportionate interest therein having vested

> in the then-shareholders as individuals. The result is unaffected by the fact that distribution in cash may have been contemplated as the assets set aside were realized upon."

The holding of the Supreme Court of the United States in the *Jerome* case has been followed by every court which has had occasion to pass upon the question. Thus, in *Continental Securities Co.* v. *Northern Securities Co.*, 66 N. J. Eq. 274, 57 Atlantic 876 (1904), a corporation reduced its capital and proposed to pay to its shareholders the surplus created by the reduction, whereupon an injunction was sought to prevent the execution of the plan. In denying the injunction the Court said:

> "By the reduction of the capital stock of a corporation, not impaired by losses, there must necessarily occur a surplus of assets to the extent of the reduction; and unless the rights of creditors will be affected thereby, or the capital impaired, it becomes the duty of the directors to make an equitable distribution of such surplus, * * *. The proposed distribution is not a dividend, in the sense intended by the statute, but a division of surplus capital rendered useless for the purpose usually attributable to capital, because the issue of stock which it represented has been canceled."

In *Seeley* v. *New York National Exchange Bank of New York*, 8 Daly (N. Y.) 400, affirmed without opinion 78 N. Y. 608 (1879), the Court held that where a company reduces the amount of its capital stock, it must return to the stockholders the whole of the capital set free by such reduction, and cannot retain a portion of it for use as a surplus fund or for other purposes. In rejecting the contention that it was discretionary with the directors either to return the money to the shareholders or to retain

it for use by the company, since by retaining it the company would do no injury to the shareholders inasmuch as the shares would increase in market value as they diminished in number and therefore the shareholders would own the same proportionate interest in the corporation as before, the Court said:

> "It is true that his proportion of the capital stock will relatively be as great as before the reduction; but it is altogether matter of conjecture as to the future market value of a share of the reduced stock. The return of the reduced capital to the shareholder is not, however, a subject for the exercise of a director's discretion.
>
> "If the retired capital be a liability of the corporation in favor of the shareholders who give up the stock that is called in, the payment of that debt cannot lie in any man's discretion. Payment cannot be deferred because the directors believe it for a creditor's advantage to keep him out of his money.
>
> "When a dividend has once been declared, the directors cannot afterwards refuse to pay it, because they have determined to establish a surplus fund with a view to benefit the corporation and its stockholders. The dividend, when declared, becomes a debt, and cannot thenceforth be disposed of without the consent of him who is entitled to it. * * * It would be strange if capital—capital which has accomplished its mission—could be diverted from its owners, and used against their protest to build up a surplus fund, when even a dividend, once declared, cannot be."

To the same effect see *Roberts* v. *Roberts-Wicks*, 92 N. Y. S. 387 ( ); *In re Artisans Land and Mortgage Corporation* (1904), L. R. 1 Chancery 796; 5 *Thompson on Corporations*, 3d Ed., §3695; 5 *Fletcher's Cyclopoedia of*

Law of Private Corporations, Vol. 5, §3472; 1 *Morawetz on the Law of Private Corporations,* 2d Ed., §443.

On the authority of the decision of the Supreme Court of the United States in *Jerome* v. *Cogswell,* supra, the decisions of the state courts, and the text writers heretofore referred to, it is submitted that by operation of law it became the duty of The Karl Kiefer Machine Company to repay to its shareholders the $122,000 surplus created by the reduction of its common stock from $150,000 par value to $28,000 par value in 1914; that Mrs. Rheinstrom and Karl Kiefer, as the owners of one-half each of the stocks surrendered and cancelled, thereupon became each entitled to one-half of that sum; that since the cost of the stock when it was issued and the amount to which they were entitled when the stock was called in and cancelled, was the same, viz: $122,000, or $61,000 each, when the Company in 1934 paid Mrs. Rheinstrom and the legatees of Karl Kiefer that amount, no gain or loss resulted, and no income subject to taxation under the provisions of the Revenue Act of 1934 was realized from the transaction.

In the court below counsel for appellee based his entire case, and the decision of the Court below was likewise based upon the assumption that the reduction in the capital stock of The Karl Kiefer Machine Company and the cancellation of the 1220 shares of stock was only a bookkeeping transaction; and that in reality the relation of the parties with respect to each other and to the corporation remained unchanged by reason of changes in its capital structure. (See Findings and Conclusions of the Judge below, R. 63, 65, 66).

In this contention counsel for the appellee and the District Court fell into error due to a misapprehension of fact on their part. That error lies in their assumption that Karl Kiefer and Mrs. Rheinstrom must be treated

as if each owned one-half of all the capital stock of The Karl Kiefer Machine Company, both common and preferred, whereas the fact was that prior to and subsequent to the reduction of the common stock there were outstanding 420 shares of preferred stock of the par value of $100 each, all of which were owned by Karl Kiefer, and Mrs. Rheinstrom owned no preferred stock whatever in the Company (R. 83).

The nature of the preferred stock in The Karl Kiefer Machine Company, owned in its entirety by Karl Kiefer, is indicated by the Company's Articles of Incorporation:

> "The Capital Stock of said corporation, common and preferred shall be Five Hundred Thousand Dollars ($500,000), consisting of Three Thousand (3000) shares of Common Stock of the par value of One Hundred Dollars ($100) each, and two thousand (2000) shares of Preferred Stock of the par value of One Hundred Dollars ($100) each; and the holders of the preferred stock shall be entitled to a dividend of six per cent per annum, payable quarterly, out of the surplus profits of the company for each year in preference to all other stockholders and such dividends shall be cumulative. The holders of said preferred stock shall not have the right to vote." (Def's Ex. A)

This excerpt from the Articles of Incorporation shows that the shareholders of the company, both common and preferred, stood on equal footing with the exception of a preference as to the payment of dividends and a limitation upon their voting privilege. Thus, the *right of the holder of the preferred stock to share in the assets of the company upon dissolution was not in this case circumscribed by a provision,* ordinarily found in such shares, *restricting the holder thereof to a return of their par*

value plus accumulated dividends upon distribution of the assets of the company on dissolution. The par value of each class of stock in The Karl Kiefer Machine Company, common and preferred, was $100 per share, and each share thereof represented precisely the same fractional capital interest in the company.

In this situation, upon a distribution of the assets of the corporation, the preferred and common stockholders would together divide the surplus in proportion to the number of shares of each. In *Continental Insurance Co., et al.,* v. *United States, et al.,* 295 U.S., 156, 181, 66 L. ed. 871, 888 (1922), the common stockholders claimed the entire surplus of a corporation upon dissolution, to the exclusion of the preferred. The United States Supreme Court rejected this claim and restated the well established rule that where there is no restriction stated in the Articles or Charter on the preferred stock's right to share upon dissolution, the preferred had an equal right with the common to share in the surplus on dissolution.

There being no restriction on the preferred's right to share in the present case, the same rule applied. Accordingly, Mrs. Rheinstrom's and Karl Kiefer's respective proportionate share of the assets of the corporation to which they would have been entitled upon dissolution, before and after the reduction in capital, respectively, is shown by the following tabulation:

BEFORE REDUCTION IN CAPITAL

	Common Stock Shares	Preferred Stock Shares	Total Common and Preferred	Proportion of Holdings to Total.
Mrs. Rheinstrom	750	0		$\frac{750}{1920} = 39\% = 2/5$
			1920	
Karl Kiefer	750	420		$\frac{1170}{1920} = 61\% = 3/5$

AFTER REDUCTION IN CAPITAL

	Common Stock Shares	Preferred Stock Shares	Total Common and Preferred	Proportion of Holdings to Total.
Mrs. Rheinstrom	140	0		$\frac{140}{700} = 20\% = 1/5$
			700	
Karl Kiefer	140	420		$\frac{560}{700} = 80\% = 4/5$

Thus Mrs. Rheinstrom's proportionate ownership in the company was reduced from two-fifths to one-fifth, or cut completely in half by the reduction in capital and cancellation of the 1220 shares of common stock, whereas Karl Kiefer's share was increased from three-fifths to four-fifths. In addition to this very material change in their proportionate shares upon dissolution, the reduction in capital likewise caused vital changes in other rights of Mrs. Rheinstrom and Karl Kiefer as stockholders. Whereas the preferred stockholders could not vote at ordinary stockholders' meetings, they still had the right under the law to vote on complete liquidation where a three-fourths vote of all the stockholders, including the

preferred, was necessary (*Rev. Statutes of Ohio, Sec. 3256c; 98 Oh. Laws 230*). The reduction in capital, as it gave Karl Kiefer four-fifths of all the stock, whereas previously he had had only three-fifths, likewise gave him control of determining when the corporation should be completely liquidated.

In view of this situation is it conceivable that the intention of the parties could have been other than that proffered by the witness, i.e. to make the capital freed by the reduction and the cancellation of the 1220 shares callable on demand by the stockholders whose shares were cancelled? Otherwise Mrs. Rheinstrom would have given up for no consideration at all an entire one-half of her interest in the company to Karl Kiefer, with the further right on his part to say when he should take it.

The learned Judge below, however, erroneously rejected this showing that Mrs. Rheinstrom's interest in the company was reduced from two-fifths to one-fifth and Karl Kiefer's increased from three-fifths to four-fifths, because, contrary to the decision in the *Continental Insurance Company* case, *supra*, he ignored completely the fact that under the law the preferred stock had equal rights with the common to share in the surplus upon dissolution (See R. 63). In this we submit he fell into serious error that resulted in an entire misconception of the case, which was further aggravated by the erroneaus exclusion of the proffered testimony above mentioned.

III.

Section 115 of the Revenue Act of 1934 does not Sanction the Imposition of the Federal Income Tax upon Corporate Distributions in Payment of the Cancellation of Stock or Other Distributions Properly Chargeable to Capital Account.

It has been the appellant's contention throughout this brief that the surrender of the 1220 shares of common stock of The Karl Kiefer Machine Company in 1914 was the beginning and the payment of the $122,000 by that company in 1934 was the end of the single transaction necessary to constitute performance of the express agreement which underlay the resolutions passed by the stockholders and directors at their meetings in November, 1914, and to carry out the company's obligation as a matter of law regardless of any express agreement. The parties to this proceeding agree that the stock was surrendered and cancelled in 1914 and they agree that the company paid the $122,000 in 1934. The only point on which they disagree is whether the payment made in 1934 was a return of the Rheinstrom and Kiefer capital investment or whether it was the distribution of a dividend. The appellant asserts that on the facts proved or provable under the rules of evidence the payment made by the company in 1934 was to discharge its obligation to repay the capital invested in the stock which was surrendered and cancelled. The only question remaining for consideration is whether Congress in Section 115 of the Revenue Act of 1934 sanctioned the imposition of the income tax upon a payment so made.

Section 115 (c) of the Revenue Act of 1934 provides in part that

> "Amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. * * *
>
> "In the case of amounts distributed, whether before January 1, 1934, or on or after such date in partial liquidation * * * the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distribution by the corporation",

and in subsection (i) of the same section the phrase "amounts distributed in partial liquidation" is defined to mean

> "a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

Section 115 (d) provides as follows:

> "*Other distributions from capital.* If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in Section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property."

It is obvious from Section 115, paragraphs (c) and (d), that Congress intended that distributions could be made which were properly chargeable to capital account free

from tax irrespective of paragraphs (a) and (b) of the same section, and that Congress did not intend paragraphs (a) and (b) of that section to create a conclusive presumption which would render a capital distribution income for the purposes of taxation. As will be shown hereafter, it is beyond the constitutional authority of Congress to attempt to define income to be taxable within the Sixteenth Amendment so as to embrace distributions which are in a real sense capital and not income. In short, Congress can not by definition make capital income. Of course it must therefore be presumed that Congress did not intend to do what it had no power to do.

Manifestly the above quoted provisions were intended by Congress to permit a corporation partially to liquidate its outstanding shares of stock without reference to the provisions of the other subsections of Section 115, subject only to the determination of gain or loss from such liquidation and distribution under the provisions of Section 111, of the Act. See *House Reports, 68th Congress, First Session, Vol* 1, *Reports,* 179, page 11; *Senate Reports, 68th Congress, Vol.* 1, *1st Session, Rep.* 398, pages 11 and 12; *House Reports, 68th Congress, First Session, Vol.* 4, *House Report* No. 844. page 14.

While a casual reading of the language used by Congress in Section 115(c) of the Revenue Act of 1934 dispels any doubt about its intention to exclude from income distributions in complete cancellation or redemption of all or a part of the stock of a corporation, that conclusion is confirmed by a consideration of the cases in which current earnings have been used by the corporation to reimburse a stockholder for his capital investment allocated to stock issued as a stock dividend, and in which the contention of the Government has been that such cancellation and redemption was part of a scheme to dis-

tribute current earnings of the corporation in the guise of a partial liquidation of the stock. Thus, in *Brown* v. *Commissioner*, 69 F. (2d) 602 (1934), certiorari denied sub nom. *Helvering* v. *Brown*, 293 U. S. 570, 55 S. Ct. 81, 79 L. Ed. 669 (1934), where part of a stock dividend issued by the corporation in 1922 was redeemed and paid for in 1925 when the company had earnings accumulated since February 28, 1913, on hand sufficient in amount to make the payments, and the Commissioner claimed that the distribution was a taxable dividend, the Court held that it should be treated as a payment in exchange for the stock and therefore properly chargeable to the capital account. Likewise, in *Commissioner* v. *Babson*, 70 F. (2d) 304 (1934), certiorari denied sub nom. *Helvering* v. *Babson*, 293 U. S. 571, 55 S. Ct. 107, 79 L. Ed. 669 (1934), where substantially the same problem was involved and the Government contended that Congress intended to tax as a dividend every distribution by a corporation of earnings accumulated after February 28, 1913, unless the distribution were in the form of a stock dividend, or unless the amounts were distributed in complete liquidation of the corporation, the Court said that a bone fide distribution in liquidation should not be considered as a taxable dividend. See also *Commissioner* v. *Rockwood*, 82 F. (2d) 359 (1936), where the Court said:

> "We believe that whatever may have been the intent of the company in accumulating and conserving profits for several years, unless there is some evidence to show that the retirement of preferred stock therefrom was previously conceived with intent of evasion, the normal situation exists, and we have merely a return of invested capital."

Commissioner v. *Ahlborn*, 77 F. (2d) 700 (1935); *Commissioner* v. *Cordingley*, 78 F. (2d) 118 (1935).

In several of the cases referred to, the contention was made by the Government that a distribution cannot be in partial liquidation under Section 115(c) of the Revenue Act of 1934, unless the corporation at the time is planning a cessation of business or is in the process of final liquidation. But the Court, in *Commissioner* v. *Quackenbos*, 78 F. (2d) 156 (1935), found it hard to perceive the force of such a contention, saying:

> "A redemption of a part of the stock of a corporation, whether it be of all of a class such as of preferred stock, or of a part of the common stock, has no necessary relation to the winding up of the corporation."

This case was followed in *Patty* v. *Helvering*, 98 F. (2d) 717 (1938). See also *Commissioner* v. *Champion*, 78 F. (2d) 513 (1935).

From these cases, as well as from the language of the Act itself, the conclusion necessarily follows that under the various revenue acts beginning with that of 1924, any distribution in cancellation or redemption of all or of a *portion of the capital stock* of a corporation, whether originally subscribed or issued as a stock dividend *is not taxable as a dividend, regardless of the amount of earnings on hand accumulated after February* 28, 1913, *at the time of the distribution,* except where the issuance of a stock dividend and its cancellation are part of a scheme to distribute such accumulated earnings. Nor does there have to be any winding up of the corporation; it may continue in business as usual.

It has never been contended by the Government in this case that the distribution in liquidation of the stock redeemed and cancelled was part of a scheme to distribute earnings accumulated by the company since February 28, 1913, for the reason that the reduction in the capital

stock of the company and its redemption and cancellation occurred long before any one had thought of subsection (b) of the Revenue Act of 1934 or its predecessors. As heretofore pointed out, the redemption of the stock in the case at bar was upon the express understanding that the subscription price therefor would be repaid, and when it was repaid in 1934, the payment was made out of capital and not out of earnings. Under these circumstances, it was not a dividend and therefore it cannot be taxed as such.

A. The Same Distribution in the Case of Another Stockholder was Held by the Bureau to be a Return of Capital. To tax a Return of Capital Would be Unconstitutional.

The purely capital nature of the entire transaction in the case at bar is strikingly shown by the situation of appellant, The First National Bank, Trustee under the will of Karl Kiefer. It will be remembered that under Karl Kiefer's will, one-third of his estate was bequeathed to the Bank, in trust, to pay the income thereof to Adele Kiefer for life and upon her death to pay the principal to the designated remaindermen (R. 84). When the bank received one-third of Karl Kiefer's share of the $61,000, it retained the same as principal under the trust and proposed to pay Adele Kiefer only the income received on that amount for life, and to hold the principal of that sum for the benefit of the remaindermen (R. 85). Inasmuch as the payment was a capital distribution the bank could do nothing else. Adele Kiefer, recognizing that the bank's position was unassailable, made even no effort to claim the payment as income which she would have been entitled to as a life tenant had it in fact been income.

The Bank's position also has full support of the Ohio authorities. In *Cleveland Trust Co.* v. *Hickox, et al.*, 32 Ohio App. 69, the law of Ohio governing a distribution as that in the present case is set down very clearly. In that case a corporation called in and redeemed its par value stock and issued new par value stock instead, also making a cash distribution of $100 per share at the same time. Both the life tenants and the remaindermen claimed the cash distribution. The trustee asked for instructions. In affirming the lower court in its holding that the cash distribution went to corpus, the court said at pagae 80—

> "The Court can not declare a dividend or create income or earnings out of the act of the stockholders and directors in consummating the agreement authorized by the resolution, and, if the court exercised such power in the face of the fact that the deal was fully and finally consummated, it would so irrevocably confuse the situation that chaos only would result, because the old stock has been cancelled by the issue of the no par stock, and the corporation, newly organized, is operating upon a basis substantially different in legal character.
>
> If there is an exchange of corporate stock by the trustees, which in and of itself is part of the corpus, it is absolutely immaterial as to whether the other party with respect to the exchange is the corporation issuing the stock or some other party. If there is liquidation of a corporation, partial or complete, the determining element of the transaction is whether the stockholders surrender and cancel the stock which is given in exchange, and the same is true as to a partial exchange of corporate assets for new securities in case of partial liquidation."

See also, *Wilberding, Adm'r.* v. *Miller,* 90 O.S., 28, 106 N.E. 665, *Lamb* v. *Lehmann* 110 O.S., 59, *Restatement of Law on Trusts,* Section 236 (f).

To similar effect, see *In Re Opperman's Estate* (Pa. 1935) 179 Atl. 728, where the Court held that a distribution of the surplus created by a reduction in capital was principal and belonged to the remaindermen.

The United States Supreme Court supports the same principles in its analyses of capital and income.

See

Lynch v. *Turrish,* 247 U. S., 221, 62 Law Ed. 1087,
Southern Pacific Co. v. *Lowe,* 247 U. S. 330, 62 L. Ed. 1142,
Lynch v. *Hornby,* 247 U. S., 339, 62 Law Ed. 1149,
Gibbons v. *Mahon,* 136 U. S., 549, 34 Law Ed. 525,
Towne v. *Eisner,* 245 U. S., 418, 62 Law Ed. 372,
Peabody v. *Eisner,* 247 U. S., 347, 62 Law Ed. 1152,
Eisner v. *Macomber,* 252 U. S., 189, 64 Law Ed. 521.

In *Girard Trust Company, et al.,* 32 B.T.A., 926, the administrators of a trust were not sure whether the accumulated surplus of a corporation in which they held the stock belonged to the life tenants or to the remaindermen. They were afraid that if the corporation declared a cash dividend in a large amount there might be a disagreement between the life tenants and the remaindermen as to what portion, if any, of the dividend belonged to each class. To fix the rights of the parties beyond dispute, the administrators had the corporation call in and cancel $80,000 worth of its stock, and the administrators allocated the $80,000 received from the corporation for the stock to the corpus of the trust, calling it a return of capital. The Commissioner held the distribution taxable on the ground that the corporation had an adequate surplus of accumulated earnings from which

to have made the distribution, and claimed that this fact placed the distribution within Sections 115 (b) and (g) of the Revenue Act. The Board of Tax Appeals reversed the Commissioner, holding that the distribution was a return of capital and not essentially equivalent to the distribution of a taxable dividend and was therefore not taxable as such.

In the *Girard case* the stock redemption device was admittedly used to avoid the payment of a cash dividend (although not for the purpose of evading the tax), yet the distribution was deemed a return of capital allocable to the remaindermen and not taxable as dividends. Surely in the present case, where the redemption and cancellation were without intent to avoid anything, and were accomplished away back in 1914, long before any tax question ever could have been raised, the distribution to the trustee must all the more be considered a return of capital allocable to the remaindermen and not subject to tax as dividends.

In view of the clear requirement of these authorities, the bank as trustee had no choice but to hold the $20,333.33 it received from The Karl Kiefer Machine Company as part of the corpus of the trust estate. It paid no part thereof to the life tenant, Adele Kiefer. The Commissioner of Internal Revenue, however, at first, consistent with his claim here that the distribution was a dividend and therefore income, proposed to assess a tax on this payment against Adele Kiefer as she did not include it in her return. If the distribution was in fact a dividend from earnings, it was income and payable to Adele Kiefer as life tenant under the terms of the trust, in which case it was taxable to her whether the trustee actually paid it to her or not. (*See Section 162 of the*

Revenue Act of 1934 set forth in Appendix Post, p. 41) *Freuler* v. *Helvering,* 291 U. S., 35, 54 S. Ct. 308. The first syllabus of that case reads:

> "Income beneficiary of trust held required to pay tax not on so much of income as he actually receives, but on amount he should properly have received in any tax year".

Adele Kiefer protested against this proposed assessment, claiming that the distribution was capital, and that therefore under the trust she was not entitled to receive it as life tenant. Upon reconsideraion the Commissioner of Internal Revenue in a letter to her expressly conceded her contentions and revoked the proposed assessment (R. 59). Thus on Adele Kiefer's protest the Commissioner of Internal Revenue held the distribution to be capital and not income.

However, in spite of the fact that this $20,333.33 distribution was conceded by the Bureau to be capital, in respect to her upon Adele Kiefer's protest, it nevertheless claimed that as to The First National Bank as Trustee, this very same $20,333.33, which the Bank, consonant with the Bureau's ruling on Adele Kiefer's protest, was holding as capital, was income and taxable. Surely this could not be. It was either capital or income. It could not be both. This wholly inconsistent attitude on the part of the Commissioner of Internal Revenue produces this curious paradox. As the distribution was a return of capital to the trustee in so far as Adele Kiefer was concerned, the trustee clearly could not deduct any income tax it had to pay on this amount from the income of the trust payable to Adele Kiefer. For the trustee to pay the tax and charge it to the corpus, would be as egregiously unfair to the remaindermen for the remaind-

ermen would be charged with the tax on income (not capital gains) although under the trust they are not entitled to receive any income. Such a self-contradictory result just does not make good sense.

If the distribution was a return of capital which the Commissioner conceded it was, on Adele Kiefer's protest, it must have been a return of capital for all purposes. It could not be a return of capital to one stockholder and metamorphosed into income in the case of another. Obviously, since the distribution to the trustee was a return of capital, it was equally a return of capital to Mrs. Rheinstrom, another distributee of the same fund.

It is submitted that the action of the Bureau in the case of Adele Kiefer's protest clearly shows the true nature of the distribution, and the Bureau was guilty of grossly unfair inconsistency and discrimination in claiming the same distribution to be income and taxable to the Bank and Mrs. Rheinstrom.

We have shown before that the Revenue Act was not intended by Congress to be interpreted as it was by the Bureau in the case of appellants and that the Act itself exempts the distribution in question from tax. As suggested above, if the Act were interpreted otherwise, it would be unconstitutional. The Supreme Court in *Eisner* v. *Macomber*, 252 U. S., 189, p. 207, 64 L. ed. 521, 529, defines income as follows:

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets".

The Court went on to say that the Sixteenth Amendment gave Congress no right to tax capital without apportionment as required by Article 1, Section 2, Clause

3, and Section 9, Clause 4 of the Constitution, but was limited to authorizing a tax on income without apportionment, the Court saying, 252 U. S., 206, 64 L. ed. 528:

> "As repeatedly held, this (Sixteenth Amendment) did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income." (matter in parenthesis added).

The Court went on to say at the same place:

> "Congress can not by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitation alone that power can be lawfully exercised".

Clearly, therefore, as the distribution in the present case was capital in its real sense, Congress could not usurp powers not given it by the Constitution, including the Sixteenth Amendment, by the device of attempting to define it as income.

It is appellant's position that Congress did not intend to have the Revenue Act interpreted in the way sought by the Bureau in this case which would render it unconstitutional, but that the Bureau in requiring the tax from appellants was guilty of an unconstitutional abuse of its authority.

CONCLUSION

The distribution in the present case in 1934 was a payment by the corporation to appellants of an obligation to return the excess surplus created by the reduction in capital and the cancellation of the 1220 shares of common

stock in 1914, which obligation existed (1) by reason of the express understanding of the parties, and (2) by operation of law even without such express understanding. The Court below committed error in rejecting evidence as to such express understanding and in its refusal to recognize the real change in the respective rights of the shareholders which took place when the common stock was reduced and the 1220 shares cancelled. Section 115, clauses (c), (d) and (i) of the Revenue Act of 1934 expressly define the distribution made in the present case as one in partial liquidation and properly chargeable to the capital account and as such exempt from tax as no gain or loss was realized. That the distribution in question was wholly one of capital is further established by the fact that the Bureau of Internal Revenue itself recognized it as such when it revoked the proposed deficiency assessment against Adele Kiefer. Finally, as the distribution was a return of capital, it was beyond the constitutional powers of Congress to tax it as income, so that the Revenue Act of 1934 must be interpreted as exempting the distribution from tax or otherwise be unconstitutional.

It is respectfully submitted that the judgment of the court below in each of these two cases be reversed.

Respectfully submitted,

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APPENDIX

REVENUE ACT OF 1934.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117(a), 100 per centum of the gain so recognized shall be taken into account in computing net income. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered

a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) *Other distributions from capital.*—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

(e) *Distributions by personal service corporations.*—Any distribution made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921, shall be exempt from tax to the distributees.

(f) *Stock dividends.*—A stock dividend shall not be subject to tax.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Distribution of stock on reorganization—Effect on distributions.*—The distribution before January 1, 1934, in pursuance of a plan of reorganization, by or on be-

half of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of the section for the purpose of determining the taxability of subsequent distributions by the corporation. As used in this subsection, the terms "reorganization" and "party to the reorganization" shall have the meanings assigned to such terms in section 112 of the Revenue Act of 1932.

(i) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

SEC. 162. NET INCOME.

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year.

Revised Statutes of Ohio Sec. 3256c, 98 Ohio Laws 230; effective July 15, 1906.

> "Such agreement shall be submitted to the stockholders of such corporation at a meeting called for the purpose of taking the same into

consideration, of which ten days' notice of the time and place of holding same, and the object thereof, shall be given by registered letter containing a written or printed notice addressed to each of the persons in whose names the capital stock of the said corporation stand on the books thereof; and also by like notice published in some newspaper in the city or town where such corporation has its principal office or place of business; provided that in case all the stockholders are present at such meeting in person or by proxy, such notice may be waived in writing. At the meeting of stockholders the agreement of the directors shall be considered and a vote by ballot taken for the adoption or rejection of the same, and for each share of stock on which has been paid all the installments called for by the board of directors the holder thereof shall be entitled to one vote. The ballots shall be cast in person or by proxy, *and if three-fourths of all the votes cast* at the meeting be for the adoption of the agreement, such agreement shall become valid and binding on such corporation. Upon the adoption of such agreement by the stockholders of said corporation, the officers thereof shall execute and deliver to the purchaser good and sufficient deeds and transfers of all the property and assets of the corporation, upon the terms and conditions in said agreement provided." (Italics added).

Nos. 8850 and 8851

United States Circuit Court of Appeals

For the Sixth Circuit

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, Deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, Deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

BRIEF FOR THE APPELLEE.

On Appeals From The District Court of The United States For The Southern District of Ohio.

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Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

ON APPEALS FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF OHIO.

BRIEF FOR THE APPELLEE

OPINION BELOW

The findings of fact, conclusions of law and opinion of the District Court for the Southern District of Ohio (R. 60-67) are reported in 33 F. Supp. 917.

JURISDICTION

These are appeals from the judgments of the District Court entered on September 26, 1940. (R. 67-68, 88.) Notices of appeals were filed on September 27, 1940. (R. 68, 88.) The jurisdiction of this Court is invoked under Section 128 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether distributions by a corporation made in 1934 to appellants (or appellants' testators) were taxable as dividends or exempt from income taxation as returns of capital or as distributions in partial liquidation, under the provisions of Section 115 of the Revenue Act of 1934.

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*, p. 23.

STATEMENT

These actions are for recovery of additional income taxes and interest for the calendar year 1934, assessed against and paid by Minna W. Rheinstrom, in the amount of $24,528.39 (R. 6), and First National Bank of Cincinnati, Ohio, trustee under the will of Karl Kiefer, deceased, in the amount of $1,310.95 (R. 86), with legal interest on the amounts from the respective dates of payments thereof. The actions were not submitted to the District Court together, but they grew out of the same set of facts and were treated as one, the findings of fact and conclusions of law expressly being made applicable to each case by the District Court. (R. 60, 87.) The cases were

submitted to the District Court on the pleadings, agreed stipulation of facts and oral testimony, a jury being waived. (R. 60.) Oral testimony (R. 20-58) was taken only in case No. 8850 (No. 5191, At Law, in the court below). The pleadings (R. 1-13, 71-79) and stipulations of facts (R. 13-19, 58, 79-87) were similar in all respects essential to the issues in the cases, varying only in such matters as capacity to sue, jurisdictional prerequisites, amounts and dates of payments of taxes, etc., none of which were in dispute. The parties stipulated that there should be but one record to be used on appeal in both cases so that unnecessary duplication might be avoided for the convenience of this Court and the parties. (R. 89.)

The formal facts are, briefly:

CASE NO. 8850

The appellant brought this action for recovery of additional income taxes and interest paid for the calendar year 1934 by Minna W. Rheinstrom, in his capacity as the executor of Mrs. Rheinstrom's estate. (R. 13.) Minna W. Rheinstrom filed an income tax return for the calendar year 1934 showing a tax due in the amount of $5,484.74. (R. 14.) The appellee (R. 13) required her to file an amended return for 1934 to include as income therein $61,000 she had received during 1934 from Karl Kiefer Machine Company, and to pay additional income tax and interest amounting to $24,528.39 (R. 14). After payment of the tax and interest Minna W. Rheinstrom filed a timely claim for refund thereof with interest. (R. 18-19.) The Commissioner of Internal Revenue rejected the claim for refund (R. 19) and this action was then timely commenced (R. 1).

CASE NO. 8851

The appellant brought this action for recovery of additional income taxes and interest for the calendar year 1934, paid by it as trustee under the will of Karl Kiefer, deceased. (R. 79-80, 85.) The appellant, as trustee, filed an income tax return for the year 1934 but did not list as income $20,333.33 received from The Karl Kiefer Machine Company. (R. 84-85.) The appellee (R.2) required the appellant to file an amended return for 1934 to include as income therein the amount of $20,333.33 received from The Karl Kiefer Machine Company, and to pay additional income tax and interest amounting to $1,310.95 (R. 85). After payment of the tax and interest the appellant filed a claim for refund thereof with interest. (R. 85-86.) The Commissioner of Internal Revenue rejected the claim for refund (R. 86) and this action was then timely commenced (R. 71).

The facts applicable to both cases as found by the District Court are substantially as follows:

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908 with an authorized capital of $500,000, consisting of 3,000 shares of common stock, par value $100, and 2,000 shares of preferred stock, par value $100; 1,500 shares of common stock and 420 shares of preferred stock were fully paid up, issued and outstanding, the total paid-in capital being $192,000; as of November 30, 1914, Karl Kiefer, now deceased, was the owner of 748 shares of the common stock and Minna W. Rheinstrom, now deceased, was the owner of 748 shares of the common stock, the remaining four shares of common stock being in the names of others to qualify them as directors, and on that date, pursuant to notice, the directors au-

thorized a reduction of the capital stock from $500,000 to $70,000, reducing the authorized preferred stock to $42,000 (the amount previously issued) divided into 420 shares of $100 par value each, and $28,000 of common stock divided into 280 shares of $100 par value each, and a certificate of reduction of capital stock was filed in the office of the Secretary of State of Ohio to that effect; each owner of common stock thereupon received new certificates for 138 shares of common stock in exchange for the original 748 shares. The reduction of the capital stock by cancellation of the original common stock and the issuance of the new stock was reflected on the books of the company by reducing the value of the common stock account from $150,000 to $28,000 and transferring the $122,000 to the surplus and undivided profits account, which then was $31,006.80, making a total of $153,006.80; in 1921, the $122,000 was again transferred to a new account, "paid in capital," but no actual distribution of any kind was made, no physical segregation of assets, nor was any other action in regard to the capital stock reduction taken until 1934, when the company, in addition to the payment of a dividend of $90,000, disbursed the $122,000 and cancelled the "paid in surplus" account, designating this payment as one which arose by the reduction of the common stock in 1914. The $122,000 was distributed as follows: $61,000 to Minna W. Rheinstrom and $61,000 to the beneficiaries under the will of Karl Kiefer, one-third, $20,333.33 to the First National Bank, as trustee under the will of Karl Kiefer, one-third to Adele W. Kiefer, Karl Kiefer's widow, and one-third to brothers and sisters of Karl Kiefer. (R. 60-62.)

The earnings of The Karl Kiefer Machine Company for the year 1934 were more than sufficient to pay the $90,000 dividend and the $122,000, the item in issue in this action. (R. 62.)

The earnings of The Karl Kiefer Machine Company for the years 1910, 1911, 1912 and 1913, were $148,006.80, out of which dividends of $87,000 were paid. (R. 63.)

The District Court also found that there was no real change in the stockholders' position with respect to the company when the 1,220 shares of common stock were cancelled in 1914; that Karl Kiefer owned all of the preferred stock before 1914; that before 1914 Karl Kiefer owned 748 shares of the common stock (1/2) and Minna W. Rheinstrom owned 748 shares (1/2); that after the change Karl Kiefer still owned all of the preferred stock and 138 shares of common stock (1/2) and Minna W. Rheinstrom still owned one-half of the common stock (138 shares); that since there was no reduction in the assets of the company and no segregation or distribution of any kind the 138 shares of common stock owned each by Karl Kiefer and Minnie W. Rheinstrom actually represented the same proportionate interest as had the 748 shares formerly owned by each; that in 1934, twenty years after the change in numbers of shares held by the stockholders, Minna W. Rheinstrom and the Karl Kiefer estate still owned the same proportion of common stock subject, in 1934 as in 1914, to the 420 shares of preferred stock (R. 63); that when the common stock was reduced from 1,500 shares to 280 shares and the 1,220 shares of common cancelled the transaction was reflected on the books by merely reducing the common stock value account from $150,000 to $28,000 and increasing the surplus account by the difference of $122,000; that there was no reduction or liquidation of assets, or segregation thereof, or distribution of any kind ordered or made (R. 65); that this transaction did not alter the pre-

existing proportionate interest of any stockholder and that the new certificates of common stock issued to Minna W. Rheinstrom and Karl Kiefer merely decreased the number of shares with proportionate enhancement of the value of each share (R. 66); that in the reduction in the number of shares of capital stock and the transfer of $122,000 to surplus at the expense of the capital stock account nothing was done remotely suggesting a partial liquidation; that on the contrary, the $122,000 was retained in the business actively working for twenty years and helping to produce the corporation's constant earnings and dividends (R. 67).

The District Court concluded as matters of law: That the net earnings of The Karl Kiefer Machine Company in 1934 were more than sufficient to pay the ordinary dividend of $90,000 and the item of $122,000 in issue; that the appellants failed to sustain their burden of proof; and that the payment of $122,000 to stockholders was a distribution taxable as dividends under the provisions of the applicable internal revenue laws. (R. 67.)

The judgments for the appellees were entered on September 26, 1940, in accordance with the District Court's findings of fact and conclusions of law, and these appeals followed.

SUMMARY OF ARGUMENT

The revenue laws define a dividend as any distribution made by a corporation to its stockholders out of earnings and profits and create a conclusive presumption that any distribution is made out of the most recently accumulated earnings. The earnings of The Karl Kiefer Machine Company in 1934 were sufficient to cover all distributions in-

cluding the amounts involved in these cases. Accordingly, the action of the Commissioner of Internal Revenue in holding the distribution taxable as dividends was in strict accordance with the law.

A distribution need not be called a "dividend" in order to be taxed as such and neither book entries, names or the corporate intention prevail against the statutory presumption.

The distributions in 1934 were not in payment of stock cancelled in 1914. The number of authorized shares of common stock of the corporation was reduced in 1914. The actual capital structure, however, was not affected. No money or assets was distributed or segregated and no other action was taken with regard to the claimed capital stock reduction. The original capital remained in the corporation actively working and earning dividends throughout the period 1914 to 1934. The only change that was made was in bookkeeping. The capital stock account was reduced from $150,000 to $28,000, and the difference of $122,000 was set up as surplus.

The District Court did not err in excluding proffered testimony relating to the background and purpose of the directors in reducing the number of shares and the claimed agreement to pay therefor. The testimony was largely hearsay, opinion, or irrelevant. If there was technical error in excluding evidence it was harmless because the court's findings show that the evidence was, in fact, carefully considered.

The corporation did not become obligated as a matter of law to repay the value of shares surrendered in 1914. The distribution in 1934 was not in satisfaction of such an obligation. There was an apparent but no real reduction

in capital structure in 1914. The capital investment remained constant. The number of shares merely was reduced with consequent enhancement of value of each share. The preexisting proportionate interests of the two common stockholders was not altered by the reduction in number of shares. Each stockholder was entitled to the same dividends as before the change. The only possible change was in the proportionate distribution of assets upon complete dissolution. That would not affect the question whether there was a return of capital in payment of stock.

The distribution in 1934 was not in payment for stock redeemed in 1914 as a partial liquidation. The question whether a distribution is in partial liquidation is one of fact. The District Court's finding that there was no partial liquidation should not be disturbed as there was no evidence upon which the court could make a different finding.

ARGUMENT

I

The Distributions to the Stockholders in 1934 Were Taxable as Dividends Since the Accumulated Earnings of the Karl Kiefer Machine Company in 1934 Were More Than Sufficient to Pay All Distributions Made.

The applicable revenue law (Section 22 (a) and (d) of the Revenue Act of 1934) expressly provides that dividends shall be included in gross income and that distributions by corporations shall be taxable to the shareholders as provided in Section 115 of the Revenue Act of 1934. Section 115 (a) and (b) of the Revenue Act of 1934, Ap-

pendix, *infra*, provides that the term "dividends" means any distribution made by a corporation to its stockholders out of earnings or profits accumulated after February 28, 1913, and that every distribution is made out of the most recently accumulated earnings or profits. The statute thus creates a conclusive presumption that any distribution is made from the most recently accumulated profits and hence the corporation may not allocate such distribution to any other fund so long as the earnings are sufficient to cover the payments.

It is undisputed that the earnings of The Karl Kiefer Machine Company for 1934, prorated to each dividend payment date, plus earnings of the corporation accumulated since February 28, 1913, and on hand January 1, 1934, were more than sufficient to cover all payments made to the stockholders during 1934. (R. 18, 62, 84.) Accordingly, the appellee submits that the action of the Commissioner of Internal Revenue in holding that the distribution of $61,000 and $20,333.33, made by The Karl Kiefer Machine Company in 1934 to Minna W. Rheinstrom and First National Bank, Trustee, respectively, were taxable as dividends, and in rejecting the claims for refunds of additional income taxes assessed thereon (R. 14, 19, 85, 86) was strictly in accord with the provisions of the internal revenue laws. The decided cases sustain the appellee's position. *Douglas* v. *Edwards*, 298 Fed. 229 (C. C. A. 2d), reversed on another point, 269 U. S. 205; *Leland* v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656; *Hadley* v. *Commissioner*, 36 F. (2d) 543 (App. D. C.); *Christopher* v. *Burnet*, 55 F. (2d) 527 (App. D. C.); *Lincoln Nat. Bank* v. *Burnet*, 63 F. (2d) 131 (App. D. C.); *Faris* v. *Helvering*, 71 F. (2d) 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Walker* v.

Commissioner, 26 B. T. A. 494, petition for review dismissed without opinion, 74 F. (2d) 1022 (C. C. A. 9th), and cases cited in the above opinions.

Moreover, a distribution need not be called a "dividend" in order to be taxable as such, and neither book entries, names, nor the corporate intention prevail against the statutory presumption. Thus, in the case of *Leland* v. *Commissioner, supra*, the directors of the corporation intended and understood that they were distributing a part of the paid-in surplus or capital, not dividends; in *Faris* v. *Helvering, supra*, the distribution was intended to be out of capital assets; in *Lincoln Nat. Bank* v. *Burnet, supra*, the directors considered the distribution, in part, a gift; in *Anketell Lumber & Coal Co.* v. *United States*, 1 F. Supp. 724 (C. Cls.); *Christopher* v. *Burnet, supra*, and in *Chattanooga Sav. Bank* v. *Brewer*, 17 F. (2d) 79 (C.C.A. 6th), certiorari denied, 274 U. S. 751, it was contended that the distributions were loans. Nevertheless, it was held in all of these cases, and many similar cases which might be cited, that the distributions were taxable dividends since the corporations had earnings accumulated after 1913 sufficient to pay the distributions.

The necessity for the statutory presumption upon which the appellee relies, its essential justice and validity, and its repeated acceptance by the courts, is succinctly explained in the case of *Leland* v. *Commissioner, supra*, where the court said (p. 525):

> Nor do we think that Congress exceeded its constitutional power by providing that, so long as a corporation has on hand earnings and profits accumulated since 1913, any distribution to its stockholders should be conclusively presumed to be a dividend out of such earnings or profits. It is evident that Congress intended that a stock-

> holder, to whom distributions were made while a corporation had earnings or profits on hand, should not escape the burdens of the income tax law through the directors of the corporation undertaking to make distributions from some other source. The statute does not convert what is not income into income. It simply requires that, while there are earnings or profits, the distributions to the stockholders shall be made from such earnings or profits, and any distributions made while such earnings or profits exist shall be deemed to have been so made.

We feel that upon consideration of the conclusive presumption created by the statute this case should be ended and that even if there was an obligation created in 1914 to repay the stockholders when the number of common shares was reduced that it could not be treated for tax purposes in 1934 as paid from capital so long as there were earnings available for distribution in 1934. However, in view of the fact that the reduction in stock did not substantially affect the two individuals who held all of the common stock in equal proportions we do not concede that there was any duty on the corporation to reimburse the stockholders.

II

The Distributions Were Not Returns of Capital Through Redemption of Stock Either by Express Understanding or by Operation of Law and They Were Not Distributions in Partial Liquidation.

In an attempt to avoid the provisions of Section 115 (a) and (b) that corporate distributions are taxable dividends where there are earnings available for distribution,

the appellants advance several alternative contentions. First, it is contended that the reduction in 1914 in the number of shares held by each of the two common stockholders created a surplus of $122,000, which represented capital originally paid for the cancelled shares; that it was understood that this capital would be paid to the stockholders on demand, and that the distribution in 1934 fulfilled the corporation's obligation. (Br. 7-14.)

The fallacy in this argument is that it assumes that there was intended *and accomplished* an actual change and reduction in the corporation's capital structure and an actual change in the stockholders' position with respect to the corporation. The appellee contends and the court below held that there was effected no real change in those respects. The record establishes conclusively that from 1914 through 1934 there was no change in the corporation's capital structure by reason of the reduction in the number of outstanding shares of common stock. Whatever may have been the original purpose or intention for reducing the number of shares it stands undisputed that throughout that twenty-year period the $122,000 in issue remained undistributed, unsegregated and actively employed in the corporation's business. (R. 64-65). Moreover, the books and records of the corporation contain no acknowledgment of any debt owing to the stockholders (R. 46) and no interest was ever paid to them (R. 50).

It is true that after the reduction in the number of common shares in 1914, the books were set up differently. The common stock account was reduced by $122,000 and the regular surplus and undivided profits account was increased by the same amount (R. 61), and then again in 1921 the $122,000 was transferred to a new account designated as paid-in surplus (R. 49, 61). But in neither case was there any distribution, segregation of assets or any

other action taken in regard to the purported capital stock reduction. Taxation is a practical matter concerned with substance, not form. What actually happened, not bookkeeping entries or designations, controls in tax cases. What actually happened in this case from 1914 through 1934, so far as the reduction of common shares affected the corporation's capital structure, was precisely nothing. The actual capital investment in the corporation was not reduced in 1914; it was merely divided into two accounts on the books, capital stock, $28,000, and surplus, $122,000, whereas, formerly, there had been carried only one account, capital stock, $150,000. The stockholders did not pay in the $122,000 as "surplus", "paid-in surplus", or "paid in capital surplus", as successively designated on the books. The item was set up on the books by subtracting it from the original common stock account. The stockholders' investments did not change but remained constant regardless of the book entries. The fact that $122,000 of the $212,000 distributed to the stockholders in 1934 was charged against the "paid-in surplus" account to close it out does not alter the substance of the transaction. There were then on hand earnings accumulated since 1913 out of which the distribution was made. No actual capital, as originally paid into the company, was distributed to the stockholders. It is to be recalled that even after the $212,000 of distributions were made in 1934 there still remained a surplus of more than $390,000 (R. 51), still huge in proportion to the original capital investment of $192,000.

In the light of what actually transpired it is exalting form over substance to urge that common stock was cancelled in 1914, a fund created for the actual redemption thereof by payment whenever demanded, and the fund allowed to remain unsegregated, undistributed, bearing

no interest but working in the corporation's business, until after a lapse of twenty years (when the corporation's accumulated earnings had reached very large proportions), it was decided to pay off the obligation.

The appellants argue at length that the District Court erred in rejecting testimony offered relating to the background and purpose of the directors in reducing the number of common shares and the claimed agreement to pay therefor upon demand. (Br. 7-14.) At the trial there was a rather extended discussion among the court, counsel for both parties, and appellants' witness, James A. Rheinstrom, in this connection. (R. 29-34, 41.) Examination of this portion of the record, we believe, will demonstrate that the District Court's rulings were correct, as much of the testimony proposed was flagrant hearsay and opinion evidence not admissible in any court. Moreover, since the controlling factor in this case is what was actually done rather than the purpose of the directors, their intent becomes irrelevant and immaterial. The books and records of the corporation were in evidence (appellants' Exhibits 1, 2, 5, 6A, 6B, 7, 8, 9, 10, and appellee's Exhibits A, B, C, D, and E (R. 35, 38-39, 42, 43, 52, 53)), and they accurately reflected everything that was done in connection with the reduction in the number of common shares. The testimony offered by the appellants could neither vary the effect of the actual transaction, nor aid the court in determining what was done or the reasons therefor. While it is true, as the appellants state (Br. 9), the cast of subdivision (a) of Rule 43, Federal Rules of Civil Procedure, is toward admissibility, rather than exclusion, of testimony, it is still the universal rule of federal courts that flagrant hearsay and opinion evidence and evidence clearly inadmissible as irrelevant and im-

material, shall be excluded. Moore's Federal Practice under the New Federal Rules (1938), Vol. 3, Section 43.02.

Even if it be assumed that the District Court was in error in excluding part or all of the testimony proffered by the appellants relating to the reduction in the number of shares of common stock, it is obvious that the error was harmless. Rule 61 of the Federal Rules of Civil Procedure is as follows:

> Rule 61. *Harmless Error.* No error in either the admission or the exclusion of evidence and no error or defect in any ruling or order or in anything done or omitted by the court or by any of the parties is ground for granting a new trial or for setting aside a verdict or for vacating, modifying, or otherwise disturbing a judgment or order, unless refusal to take such action appears to the court inconsistent with substantial justice. The court at every stage of the proceeding must disregard any error or defect in the proceeding which does not affect the substantial rights of the parties.

The formal proffer of evidence which the appellants insist was erroneously rejected is included in the following extract from the record (pp. 31-32):

> MR. GOLDMAN: If the witness were permitted to answer the question he would say that prior to the time the stock was reduced in 1914 Karl Kiefer, who was then the head of the Karl Kiefer Machine Company and who guided its policies, desired to make free for the stockholders a large portion of the then paid-in capital of the corporation, as the directors of the company considered the company at that time over-capitalized; that Karl Kiefer, in consultation with his uncle by marriage, Adolph Dreyer, desired to have available for the stockholders money which

had previously been paid into the company in the form of the then existing paid-in capital, which could not be withdrawn from the company without impairing the capital without a reduction in stock; that the by-laws of the company did not permit any officer or stockholder to borrow money for personal use on the company's credit; and it was determined to reduce the capital stock and thus create a fund which would be available to the stockholders at any time they wished to draw therefrom, and that the officers could then borrow money from the bank on the company's credit and have the use of the money themselves by drawing down the amount due from the reduction of the capital stock.

THE COURT: Do I understand you to say that the stockholders could then borrow money on the company's credit?

MR. GOLDMAN: To make that clear, Your Honor, the by-laws of the company provided that no stockholder or officer could borrow money on the company's credit and then use it himself, but by decreasing the capital stock and creating a liability of the corporation to the stockholders in this case to the extent of $122,000, that then the company could borrow money at the bank and the stockholders would have the right to the money to the extent of $122,000.

THE COURT: Kind of fantastic, isn't it?

* * *

However, in spite of the inherently improbable nature of the proffered testimony and its conflict with the transactions that actually occurred, and the rulings of the District Court sustaining the appellee's objections, it is evident that the learned trial judge did carefully consider the testimony offered for in the court's findings it is said (R. 62-63):

> Although the evdence as to the company's purpose, was rejected for various reasons, it may be well to consider the operations over the entire period in question, particularly in view of the fact that several exhibits were received in evidence bearing more or less on this phase of the case. Defendant's Exhibit H shows that the net earnings for the years 1910, 1911, 1912 and 1913 were $148,006.80 and dividends paid were $87,000. Considering that the company started with a paid-in capital of $192,000 in 1908 and had net earnings of $148,000 by the end of 1913, would seem to definitely dispose of the theory that the directors considered the company over-capitalized in 1914.

The District Court's findings that there never was any segregation of the $122,000 fund and no distribution or withdrawal thereof (R. 63, 65) establishes that consideration was also given to the fact that the fund was never used for the purpose for which it was claimed to have been created. We submit that the District Court did consider the proffered evidence, that the same conclusion would have been reached whether or not the evidence was rejected, and that no injustice was done to the appellants in rejecting the testimony. In such a case the judgment should not be reversed by a Circuit Court of Appeals even if there were technical error in excluding the evidence. (*American*) *Lumbermen's Mut. Cas. Co.* v. *Timms & Howard,* 108 F. (2d) 497 (C. C. A. 2d); *Woods* v. *Gettelfinger,* 108 F. (2d) 549 (C. C. A. 5th).

The appellants also contend that, as a matter of law, the corporation became obligated to repay the par value of the shares surrendered in 1914, and that the payment in 1934 was in satisfaction of that obligation and was paid out of capital made free by the cancellation. We believe

that it has been demonstrated above that this argument is founded upon false premises. Appellants cite and quote many cases upon the general proposition that when stock is surrendered and cancelled the corporation which calls in the stock must pay for it. (Br. 15-24.) We do not deny that the general rule is as stated but the rule is not applicable to the present case. Here there was an apparent but no real reduction in capital common stock or capital structure. The District Court made a very thorough analysis of the appellants' contentions in this regard and, we believe, fully refuted them. (R. 63-66.)

The number of issued shares of capital stock was reduced, of course, but, as the District Court pointed out, the effect of the transaction was merely to decrease the number of shares with consequent enhancement of the value of each share. In this connection the District Court quoted the case of *Eisner* v. *Macomber*, 252 U. S. 189, showing how aptly the language of that leading case applies to the present one and how the Supreme Court looks through and disregards mere bookkeeping entries to determine the essence of a transaction. (R. 65-66.)

The court below held that the preexisting proportionate interests of the two common stockholders of The Karl Kiefer Machine Company were not altered by the reduction in number of shares. (R. 63, 66.) The appellants contend that the court erred in that respect, advancing the possibility that upon complete dissolution of the corporation one of the stockholders, Karl Kiefer, might have distributed to him a larger proportion of the assets than he would if there had been no reduction in the number of common shares. For all practical purposes the District Court's holding was certainly correct. Before and after the change each stockholder owned the same proportion of the common stock and one stockholder always owned

all of the preferred stock. Necessarily, each stockholder continued to be entitled to the same proportion of the company's earnings and dividends. The voting rights and control of the corporation remained the same with the possible exception suggested by the appellants that one of the stockholders by reason of ownership of the preferred stock, might dictate the time of dissolution of the corporation, but even this is a *non sequitur*. The appellants cite Section 3256c of the Revised Statutes of Ohio (1906), which provides that upon submission by the directors of a corporation of an agreement to sell all of the corporation's property three-fourths of the stockholders may adopt the agreement and effect the sale. However, the preceding section of the law provides:

> Section 3256b. No corporation organized under the laws of this state shall sell its entire property and assets to any person, persons or associations, or to another corporation, whether organized for the same or similar purpose or otherwise, under the laws of this state, or any other state, unless three-fourths of the directors of such corporation shall authorize the execution of an agreement therefor prescribing the terms, considerations and conditions thereof, which considerations may be money, stocks, bonds, or other instruments for the payment of money, or any valuable consideration, nor shall any such sale be made for the formation of or to any trust or combination for the purpose of restricting trade or competition.

Thus it is seen that any agreement to sell the corporation's entire property must be initiated by three-fourths of the directors. Control of the directorate of The Karl Kiefer Machine Company was not affected by the reduction in number of common shares because the voting stock still remained equally divided between the two stockholders.

If there was a change in the proportionate shares of the assets that the stockholders might receive upon complete liquidation, by reason of the reduction in number of common shares, we submit that it would have no bearing upon the issues in this case. The transaction may have involved an inchoate gift from Minna W. Rheinstrom to Karl Kiefer, but it does not affect the question whether there was a return of capital resulting from the reduction in the number of shares.

As a final alternative the appellants contend that the distribution in 1934 was in payment of stock redeemed in 1914 as a partial liquidation. (Br. 25-30.) By this contention it is sought to bring the transaction within the purview of the exemptions found in Section 115 (c) and (i) of the Revenue Act of 1934, Appendix, *infra*. We believe that this contention requires no extended discussion. It is well settled that the question whether a distribution is in parial liquidation is one of fact depending upon the particular circumstances of each case. *Gossett* v. *Commissioner*, 59 F. (2d) 365 (C. C. A. 4th); *Hellman* v. *Helverding*, 68 F. (2d) 763 (App. D. C.); *Kelly* v. *Commissioner*, 97 F. (2d) 915 (C. C. A. 2d); *Ward M. Canady, Inc.* v. *Commissioner*, 76 F. (2d) 278 (C. C. A. 3d), certiorari denied, 296 U. S. 612; *Milton* v. *Commissioner*, 33 B. T. A. 4; *C. M. Menzies, Inc.* v. *Commissioner*, 34 B. T. A. 163.

In this case the District Court held that there was no distribution in liquidation, saying that (R. 64):

> * * * beyond the reduction in the number of shares of common stock and the transfer of $122,000 to surplus at the expense of the common stock account, nothing was done even remotely suggesting partial liquidation.

The court's finding should not be disturbed as it is supported by the evidence, or perhaps it is more accurate

to say that there was a complete lack of evidence upon which the court could make any different finding.

The appellants contend that the Commissioner of Internal Revenue has been inconsistent in asserting the tax against the First National Bank, as trustee, and granting a protest by the *cestui que trust* against whom a revenue agent had proposed a deficiency assessment. (R. 59-60, Br. 30-36.) It is argued that this implies that the Commissioner considered the distribution as a return of capital when he granted the protest of the beneficiary and as income when the deficiency was asserted against the trustee, and that it could not be both. The argument seems to be without merit. The Commissioner has certainly always insisted that the distribution was income to someone and the fact that he granted the beneficiary's protest carries no implication that he regarded the payment as a return of capital to anyone. In any event, the sole issue before this Court is whether the distribution was a taxable dividend or a return of capital, and even if the Commissioner has taken inconsistent positions it would have no bearing upon the question now presented.

CONCLUSION

The decision of the District Court is correct and the judgments should be affirmed.

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JULY, 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SECTION 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions in section 117 (a), 100 per centum of the gain so recognized shall be taken into account in computing net income. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorgani-

zation) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) *Other Distributions from Capital.*—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

* * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. (U. S. C., Title 26, Section 115.)

Treasury Regulations 86:

ART. 115-1. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 207 (c) (1)) comprises any distribution in the

ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, when distributed to shareholders in dividends is taxable to the same extent as other dividends.

A taxable distribution made by a corporation to its shareholders shall be included in gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

ART. 115-2.—*Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recent accumulated earnings or profits.

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

* * * *

ART. 115-3. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March* 1, 1913.—Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning

of Title I. For the purposes of the Act, a corporation can not distribute earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed.

A distribution made by a corporation out of earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, is not, as such, subject to tax, but shall be applied against the basis of the stock. For the treatment of gains from the stock, see article 111-1. The provisions of this paragraph are applicable to a distribution received by one corporation from another corporation out of increase in value of property accrued or earnings or profits accumulated prior to March 1, 1913.

* * * *

ART. 115-4. *Distributions other than those out of increase in value of property accrued prior to March* 1, 1913, *or out of earnings or profits.*—Any distribution (not in partial or complete liquidation) made by a corporation to its shareholders otherwise than out of increase in value of property accrued prior to March 1, 1913, or earnings or profits, shall be taxable to the recipient only if and to the extent that such distribution exceeds the basis of his stock as provided in section 113. Any such distribution, however, shall be applied against and reduce the cost or other basis of the stock upon which declared. For the treatment of the gains from the stock, see article 111-1.

ART. 115-5. *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The phrase "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the

corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112. The entire amount of the gain so recognized shall be taken into account in computing net income despite the provisions of section 117, but the losses are subject to the limitations in sections 24 (a) (6) and 117. In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining taxability of subsequent distributions by the corporation.

* * * *

ART. 115-9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends

upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distributon in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

United States Circuit Court of Appeals

Nos. 8850 and 8851

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee,

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

REPLY BRIEF OF APPELLANTS

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REPLY BRIEF OF APPELLANTS

REPLY TO APPELLEE'S POINT I

Appellee asserts (Br. 10) that under Section 115 (a) and (b) of the Revenue Act of 1934, a corporation may not make any distribution except from earnings, so long as the corporation has any undistributed earnings since February 28, 1913, on hand. This is simply not so, as it completely ignores the exceptions stated in paragraphs (c), (d) and (i) of the same section, which authorize, free from taxation, bona fide distributions in cancellation or redemption of stock or otherwise properly chargeable to capital account. The distributions in the case at bar come squarely within those exceptions, being made in complete cancellation and redemption of stock.

Appellee's Cases Under His Point I

The cases cited by appellee (Br. 10-11) are clearly not in point, as not a single one of them involve the cancellation or redemption of any stock. We agree that distributions made to stockholders, *if not included in the exceptions provided in paragraphs (c), (d), and (i) of Section 115,* are presumed to be dividends from earnings to the extent that earnings exist whether they are called dividends by the corporation or not. We also agree that the books of the corporation or mere forms, do not control the situation, but that the facts determine the taxability of a transaction. However, the presumptions in paragraphs (a) and (b) in Section 115, by the express language of the Act, are not applicable where a distribution is in complete cancellation or redemption of all or part of an issue of stock.

Thus, in *Douglas* v. *Edwards,* 298 Fed. 229 (C. C. A. 2d), an attempted distribution charged to depletion reserve before earnings, was not permitted. No cancellation of stock was present.

In *Leland* v. *Commissioner,* 50 F. (2d) 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656, the corporation claimed that a distribution made had been from surplus and not from earnings, although earnings were on hand. The court held that the distribution would be deemed to come from earnings. In that case there was no reduction in capital or cancellation of shares of stock at all. Furthermore, the action was taken after the earnings were made, and was obviously an attempt to evade payment of dividends from earnings. None of these factors was present in the case at bar, where there was a change in the capital structure and cancellation of stock years before there were any such accumulations of earnings, and without regard to any tax law.

In *Hadley* v. *Commissioner,* 36 F. (2d) 543 (App. D. C.), a stockholder was taxed even though the credits he received from earnings of a corporation were not formally declared as dividends or so listed on the books of the corporation. Likewise, in *Christopher* v. *Burnet,* 55 F. (2d) 527 (App. D. C.), withdrawals by the holder of all of the stock of a corporation which were charged to him on the books of the corporation as purported loans, were deemed dividends from earnings. In neither of these two cases was any stock retired, and in both there was an apparent effort to evade the tax through subterfuge.

In *Lincoln Nat. Bank* v. *Burnet,* 63 F. (2d) 131 (App. D. C.), a distribution admittedly from earnings was considered to be dividends by the court, although not termed such by the corporation. Here, again, there was no stock redeemed.

In *Faris* v. *Helvering,* 71 F. (2d) 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584, affirming 26 B. T. A. 496, and *Walker* v. *Commissioner,* 26 B. T. A. 494, both of which cases involved recipients of portions of the same distribution, an attempt was made to distribute from capital in form, without, however, retiring any stock, while earnings were on hand. Here, again, the device was an apparent effort to evade the tax. The distributions were held taxable as dividends. In each of the cases the Board of Tax Appeals was careful to point out that no stock was retired or cancelled.

In *Anketell Lumber & Coal Co.* v. *United States,* 1 F. Supp. 724 (C. Cls.), the corporation had converted all of its assets to cash and was in process of liquidation. The owners of practically all of the stock withdrew large amounts from the corporation, calling their withdrawals loans on the books of the company. The court held that the withdrawals were in reality liquidating dividends. Again, in *Chattanooga Sav. Bank* v. *Brewer,* 17 F. (2d) 79 (C. C. A.

6th), certiorari denied, 274 U. S. 751, the sole owners of the stock in the corporation made withdrawals and charged them to their accounts on the books of the corporation as loans. The By-laws prohibited loans to stockholders. The court held that the withdrawals were in reality dividends. Both of these last two cases are examples of the principle that the Court will look through form, and that reality and not subterfuge is determinative of the taxability of a transaction.

However sound all of the above discussed cases may be, they clearly bear no analogy to the case at bar, where good faith is in no way challenged, because the transaction could not have been a device to evade any tax since it was in process long before any tax question was involved; and in the case at bar there was, as there was not in any of the above cases, a complete cancellation and redemption of part of an issue of stock.

REPLY TO APPELLEE'S POINT II

Appellee under this head argues that there was no real change effected by the reduction in capital and the cancellation of the 1220 shares of common stock, and that therefore the distribution in dispute was not a return of capital or a distribution in partial liquidation. Both appellee's premise and his conclusions are erroneous.

It is said that the corporation's books do not show the $122,000 as a debt due the stockholders and that interest was not paid thereon. The testimony was however that this fund should be available to the stockholders on their demand. There is certainly nothing in the company's books to contradict such an intention. The fact that a debt from the company to the stockholders was not set up on the books or that interest was not paid, makes no difference whatever, for, the company never denied the obligation. As the company could probably have used the money profitably until

the stockholders chose to withdraw it, and in fact did pay very substantial dividends every year without exception, it would have been impractical for the stockholders to charge interest, as that would merely mean taking the money out of one pocket and putting it into another.

The law is clear that the form in which an account is carried on the books is not determinative. The cases cited by appellee himself above analyzed show this, and, indeed, this is the claim of appellee. In addition to those cases, see also *English & Mersick Company* v. *Eaton,* 299 Fed. 646; *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 187 (1918); *United States* v. *Nipissing Co.,* 202 Fed. 803, 804 (1921); *United States* v. *Guggenheim Exploration Co.,* 238 Fed. 231, 236 (1917); *Southern Pacific Railroad Co.* v. *Muenter, et al.,* 260 Fed. 837, 838 (1919); *Baldwin Locomotive Works* v. *McCoach,* 221 Fed. 59 (1915); *Forty Fort Coal Co.* v. *Kirkendall,* 233 Fed. 704, 707 (1915).

In *English & Mersick Co.* v. *Eaton,* supra, the facts were the reverse of those in the case at bar. There the company's books credited certain earnings of the company to individual stockholders' accounts as dividends after an appropriate resolution declaring dividends. The company, however, claimed that these amounts should be considered invested capital for the purpose of calculating excess profits taxes, and not borrowed capital from the stockholders. The Commissioner of Internal Revenue claimed that the company was bound by its books, and that as the books showed the amounts credited to the individual stockholders, such amounts could not be considered invested capital. The court reversed the commissioner and held in favor of the taxpayer, saying on page 648:

> "Neither the Government nor the corporation is bound or concluded by the language of any resolution in the ascertainment of corporate intent."

In *Baldwin Locomotive Works* v. *McCoach*, supra, the court said:

> "The decisions under the . . . Income Tax Law are uniform to the effect that the government cannot base a claim for taxes on mere bookkeeping."

Thus, in the case at bar, merely because the books of the company do not show an account called "Debts Due Stockholders" does not mean that the stockholders were not entitled to withdraw their shares of the $122,000 fund at any time.

The more recent case of *Weaver* v. *Commissioner*, 58 Fed. (2d) 755, is very pertinent. There the stockholders contributed $100,000 to a corporation from funds credited to them on the books of the company, with the verbal understanding that at some future date the amounts thus contributed would be returned. This fund was carried on the books in an account called "Contributed Surplus." The corporation several years later returned this sum to the stockholders, although there were earnings of equal or greater amount on hand. The Board of Tax Appeals held that the distribution was taxable. The Circuit Court of Appeals reversed, stating that the understanding of the stockholders controlled, and that the payment was equivalent to repayment of loans from the stockholders. The facts in the case at bar are a great deal stronger, as here, not only by the express understanding of the stockholders, but as a matter of law, the corporation owed the money to the stockholders.

The records, however, in so far as they reveal any intention at all, bear out plaintiff's claim in that they show that the $122,000 was not to belong to the company. If the fund was to belong to the company, the records would indicate that the full value of the 1496 shares turned in, or $149,600,

was received by the company when it issued the 276 new shares, but the stock record (Appellant's Exhibit 10), on the contrary shows that the consideration received by the company for the 276 shares of new stock issued was only $100 per share, or $27,600 rather than $149,600, clearly establishing that the $122,000 excess representing the net of 1220 shares cancelled, was not intended to belong to the company.

Counsel for the appellee contends that twenty years had elapsed between the cancellation of the shares and the payment. This clearly can make no difference. As shown by the authorities cited in our original brief (pp. 16-20), the rights of the stockholders are established at the time the reduction of capital and cancellation of certificates occurs. In the case of *Jerome* v. *Cogswell,* 204 U. S. 1 (discussed pp. 16-17 of our main brief), several years had elapsed after the reduction in capital, and the remaining stock had passed into different hands, yet the court held that the stockholders who were such at the time of the reduction, were the ones entitled to receive the distribution when it was made some years later. In fact, in the case of *In Re Artisans' Land & Mtg. Corp.* (1904), L. R. 1 Chancery 796 (cited on page 19 of our original brief) the court held that even though as much as twenty years might elapse after the stock was cancelled, the stockholder was still entitled to maintain an action against the corporation for his money where the corporation denied the obligation. In the case at bar, the corporation has never disputed the obligation and has always been willing to pay whenever the stockholders might ask for their money.

In arguing that there was no real change in the stockholders' relation to the corporation before and after the reduction in capital and cancellation of stock, appellee simply pulls himself up by his own bootstraps. It is always true that where a corporation reduces its capital and calls

in a part of its common stock, redeeming a portion of each shareholder's holdings pro rata, the proportionate ownership of the common stock remains the same before and after the reduction and cancellation. Also, until distributed, the amount of capital represented by the cancelled shares is transferred from capital to surplus, but that surplus belongs to the holders of the shares which have been cancelled. (See authorities cited pages 16-20 of our main brief.) Appellee's argument would apply with equal force in every case where all or part of an issue of stock has been redeemed and cancelled. Yet where this is done, and there is no showing of artifice or evasion, the courts have uniformly held the distribution to be tax free. The case at bar can in no way be different, in so far as the relation of the stockholders of a corporation and their proportionate interests are concerned, from any of the cases where the courts have upheld such distributions.

The Trial Court Did Err in Rejecting Evidence and Such Error Was Not Harmless

Appellee argues that the trial court was correct in excluding the testimony of James A. Rheinstrom as to the background and purpose of the reduction of capital and cancellation of the 1220 shares, saying that it was hearsay and opinion evidence, and that the parties' understanding and intention were immaterial. The testimony offered was not hearsay or opinion evidence at all. Hearsay evidence is objectionable where it is sought to show through a witness a statement of fact made by another for the purpose of establishing the truth of the facts stated. But it is always proper to adduce evidence of what persons have said, to show their understanding, intent, or purpose. See *Jones on Evidence,* Section 350. If this were not so, an oral agreement could never be proved through a third party witness who heard it made.

However, the hearsay objection was eliminated entirely from this case, as Mr. Rheinstrom was questioned as to matters which lay within his own personal knowledge and recollection, and the trial court recognized this (R. 40-41). Who would be better qualified than Mr. Rheinstrom to state the intent and purpose underlying the corporate action, inasmuch as he was present at both the directors' and stockholders' meetings, he personally made the motion to reduce the capital, and as Secretary of the Company, wrote up the minutes?

The ground on which the trial court excluded the evidence was an erroneous application of the parol evidence rule (R. 30-31). As shown in our main brief (pp. 10-14), this was clearly error. Opposing counsel tacitly admit this, as they make no effort to differentiate or even comment upon the many authorities we have cited, and, indeed, say not one word to uphold the trial judge on this point. Instead, they say that if there was error, it was harmless error. Of course, we agree that error to be reversible, must be more than technical, but must prejudice substantial rights of the complaining party, and for that reason we are in accord with the rules laid down in the cases cited by appellee (Br. 18) in support of this principle. However, the error in excluding the proffered testimony was not harmless. It was seriously prejudicial to appellants.

Our opponents say the error was inconsequential on three grounds: (1) that the testimony was inherently improbable; (2) that it was immaterial; and (3) that the trial court considered it anyhow.

There is no basis whatever for the first ground. Mr. Rheinstrom is a man of the highest integrity and honor. No effort was made to impeach him, and he was not even cross-examined. Obviously the stockholders and directors must have had some reason for their actions, but the minutes of the corporation are silent as to that reason. An examination

of the tax laws of that time shows that no tax purpose was to be served. At no stage of the case, and not even now, have opposing counsel suggested what the purpose might have been if it had been in the slightest degree different from that solemnly sworn to by Mr. Rheinstrom. Opposing counsel have quoted (Br. 16-17) from the colloquy between counsel and the trial court when the excluded testimony was proffered, where the trial court made the comment "fantastic." This shows only that the trial court unfortunately had pre-judged the case, and had closed his mind to receiving any explanation for the otherwise unexplained corporate action. The understanding, as testified to by the witness, that the stockholders would have the right to draw down upon demand their respective portions of the surplus created by the reduction in capital and cancellation of the 1220 shares of common stock, was the only reasonable one that could have existed. If this had not been the understanding, then Mrs. Rheinstrom in agreeing to the corporate action, would, in effect, have been making a gift to Karl Kiefer of one-half of her interest in the assets of the corporation, and instead of being entitled to one-half of the $122,000 fund, would have been entitled to only one-fifth of it. (See our main brief pp. 21-24.) Opposing counsel concede this (Br. 21). The supposition that Mrs. Rheinstrom would have made such a gift to Karl Kiefer without any consideration, or any other reason, might be indeed characterized as "fantastic."

Appellee, as a second ground for contending that the error was harmless, says that the purpose and intent underlying the corporate action and the understanding of the parties, were immaterial. Inasmuch as the minutes were silent on this point, what could be more pertinent than this understanding, which is one of the chief issues in the case? While it is true that the understanding testified to is presumed in law even where not expressed (see our main brief

pp. 15-20), surely evidence of such an actual express understanding does not thereby become immaterial.

Finally, appellee says the error was harmless, because the court considered the rejected evidence anyhow. This cannot be so, because the judge still adhered to his ruling in his opinion. Furthermore, as pointed out above, the judge from the beginning determined not to permit such evidence to influence him. A judge cannot possibly give proper consideration to evidence when at the same time he considers it to be inadmissible and immaterial.

It is submitted that the error in excluding testimony was substantial and prejudicial, and not harmless.

A Real Change Took Place When the Capital Was Reduced and 1220 Shares of Common Stock Were Cancelled

Appellee, while conceding (Br. 19) that when stock is surrendered and cancelled a debtor-creditor relation arises between the corporation and the stockholders as to the stock that has been cancelled, insists that this general rule is not applicable in the case at bar, because, it is contended that the proportionate interests of the stockholders remained the same after, as well as before, the corporate action was taken. We have already shown (pp. 7-8 supra) the fallacy of this contention, and that in that respect this case is in no way different from any case where the capital is reduced and stock cancelled. The same argument as appellee makes here was urged in *Seeley* v. *N. Y. National Exchange Bank of N. Y.*, 8 Daly (N. Y.) 400, affirmed without opinion, 78 N. Y. 608 (1879), and was there rejected by the court. (See discussion pp. 18-19 of our main brief.)

Opposing counsel also apparently admit (Br. 19, 21) that the reduction in capital and cancellation of the 1220 shares of common stock did change the proportionate interests of the stockholders in the assets upon final liquidation (see

our main brief, pp. 21-23); yet insist somehow that the corporate action did not in reality affect the interests of the stockholders. On the very face of it, appellee's contention refutes itself. Appellee's argument treats a stockholder's proportionate interest in a corporation's assets as being wholly unimportant, a mere technical right of no real value, whereas the right to share in the assets upon liquidation is one of the most important rights a stockholder has. The value of his stock is determined as much by the proportionate interest in the corporation's assets which the stock represents as by anything else. Thus, although U. S. Steel did not pay common dividends for several years, its common stock still had a very substantial market value. When Mrs. Rheinstrom's interest in the assets of The Karl Kiefer Machine Company was cut in half by the corporate action in this case, she most certainly did suffer, not an insubstantial, but a very real change in position. The decision of the court below in effect, has, ex post facto, taken three-fifths of Mrs. Rheinstrom's interest in the $122,000 fund, and has given it to the legatees of Karl Kiefer.

There Was a Partial Liquidation Within the Terms of the Revenue Act

Appellee argues that even though part of an issue of stock was wholly redeemed and cancelled in this case there was no actual liquidation because the corporation continued in business as before. Appellee falls into the same error as the court below did in assuming that to have a "distribution in partial liquidation" under Section 115, it is necessary to have a partial cessation or curtailment of the corporation's business. This error arises through the failure to recognize that, as used in Section 115, "amounts distributed in partial liquidation" *are words of art*, and do not necessarily have their ordinary meaning outside of that section. Paragraph (i) of Section 115 expressly states:

> "As used in this section, the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

Paragraph (c) of Section 115 specifically excepts such "amounts distributed in partial liquidation" from the presumption in paragraph (b) of the same section that all distributions are to be deemed to be made from earnings to the extent that such earnings are on hand.

Under the definition in Section 115 (i), there need be no cessation or curtailment of business activities to have a distribution be one "in partial liquidation." So the courts have held.

In *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156 (1935) (C. C. A. 2nd), the court said at page 157:

> "A redemption of a part of the stock of a corporation, whether it be all of a class, such as of preferred stock, or a part of the common stock, has no necessary relation to the winding up of the corporation. . . .
>
> "Retirement of a portion of the stock of a corporation does not wind it up, and under sub-section (c), the distribution which is properly chargeable to capital account shall not be considered as a distribution of earnings or profits within the meaning of subsection (b)."

This language was followed with approval in *Kelly* v. *Commissioner*, 36 B. T. A. 507, at 515, and in *Britt* v. *Commissioner*, 40 B. T. A. 790, at 796-7.

In *Salt Lake Hardware Co.* v. *Commissioner*, 27 B. T. A. 482, a taxpayer who had previously received stock dividends which were redeemed, claimed (in order to avoid the normal tax on capital gains) that the distribution was a dividend from earnings, and not in partial liquidation, because the

company did not contemplate curtailing or winding up its business. The Board said at page 486:

> "That argument can have persuasive force only by using the word 'liquidation' in the sense of winding up the affairs of the company. Admittedly that is the usual meaning given to the word. But here we cannot ignore the fact that Congress has established a different meaning for income tax purposes. As set forth in the statute, section 201, supra (now section 115), a partial liquidation takes place whenever a corporation distributes money or assets in complete cancellation or redemption of a part of its capital stock."

The conclusions of the cases just cited not only are necessitated by the clear language of the statute, but are required as well by the discussion in the Committee Reports when Section 115 and its predecessors were pending in Congress. For the court's convenience we give excerpts from those reports in the Appendix, p. 17, infra.

Appellee's Cases

The cases cited by the appellee (Br. 21) are not at all analogous to the one at bar.

In *Gossett* v. *Commissioner*, 59 Fed. (2d) 365 (C. C. A. 4th), and in *Ward M. Canady, Inc.* v. *Commissioner*, 76 Fed. (2d) 278 (C. C. A. 3rd), the corporations were in the process of being wound up and distributions were made to stockholders. To avoid the normal tax on capital gains, the stockholders claimed the distributions were from earnings, but the courts held that since the corporations were actually in liquidation, the distributions would have to be considered as liquidating dividends.

In *Milton* v. *Commissioner*, 33 B. T. A. 4, the taxpayer had first claimed that a corporation had liquidated in 1929. Some years later after the statute of limitations had run

against his 1929 return, he found it to his advantage to claim that the corporation had liquidated in 1930. The Board held that actual liquidation was a matter of fact, and that the taxpayer's evidence was insufficient to overcome the commissioner's findings, and further that the taxpayer was estopped from changing his claim.

In *Menzies, Inc.* v. *Commissiomer,* 34 B. T. A. 163, the entire assets of a corporation were transferred to its largest stockholder in exchange for a note. The note was eventually paid in full. The corporation continued to pay its franchise and income taxes but invested its funds in real estate. The stockholder claimed the transaction was a sale and not a distribution in liquidation. The Board upheld the taxpayer, stating that from the facts there was a bona fide sale and not a liquidation.

In *Hellman* v. *Helvering,* 68 Fed. (2d) 763 (App. D. C.), the owner of all of a corporation's stock caused it to reduce its capital and call in 500 shares so that he could take a loss on those shares and thus reduce his income tax. The court held that the whole transaction was merely a bookkeeping arrangement, nothing more than a subterfuge, and the deduction was disallowed. Clearly, none of the foregoing cases are in any way relevamt to the case at bar, for here there is no claim or proof of bad faith, subterfuge or evasion. *The stock was cancelled long before any question of taxation arose.*

The only case cited by appellee which is analogous to the one at bar is *Kelly* v. *Commissioner,* 97 Fed. (2d) 915 (C. C. A. 2nd), *and that supports not appellee's but appellants' contentions.* There a corporation reduced its capital, cancelled one-half of its stock, but continued in business. The taxpayer received less for his stock upon redemption than he had paid for it. The court held that the distribution was in partial liquidation, and followed with approval the language from the *Quackenbos* case quoted supra, p. 13.

The court distinguished the *Hellman* case, supra, page 15, cited by appellee here, pointing out that in that case the transaction was not bona fide but a subterfuge.

Appellee argues that the determination of whether a distribution is one in partial liquidation is a question of fact, that that fact has been found against appellants by the trial court, and therefore must stand. We would agree to such a statement if such a conclusion were supported by any facts and the facts were in dispute. But here the facts are all undisputed, most of them stipulated and the rest uncontroverted. In such a case the Circuit Court of Appeals is not bound by the findings of the district judge, but is free to draw its own conclusions. *Parker* v. *United States*, 88 Fed. (2d) 907 (C. C. A. 7th). In the case at bar, outside of the question on which evidence was excluded by the trial court, the only issues are ones of law. The trial court's error on the question of partial liquidation was in failing to perceive that Section 115 (i) rendered the expression, "amounts distributed in partial liquidation," words of art, and in failing to follow their meaning as defined in that paragraph.

It is urged that the judgments below be reversed with instructions to enter judgments for appellants for the reasons stated.

Respectfully submitted,

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APPENDIX

NOTE: The provisions of Section 115, paragraphs (b), (c) and (i) of the Revenue Act of 1934 have been substantially the same since the Revenue Act of 1924, but at that time were known as Section 201, (b), (c) and (g). The forerunners of Section 115, paragraphs (c) and (i) were first adopted in 1924. For that reason we include excerpts from the Committee Reports of the Congressional Committees regarding the intent and meaning of these sections.

Report of Committee on Ways and Means on the Revenue Act of 1924, H. R. 6715, 68th Congress, First Session. House Reports 179, Vol. 1, page 11.

(1) Sec. 20 (c): The existing law has no provision similar to subdivision (c) of the bill, but the Treasury has construed the existing law as taxing liquidating dividends not as capital gains, but as dividends subject to the surtax rates. The proposed bill, as did the 1918 Act, treats a liquidating dividend as a sale of the stock to the corporation and recognizes the time effect of such a distribution.

The theory of liquidating dividends is extended to distribution in partial liquidation. If a corporation retires a portion of its capital stock, the transaction is treated from the point of view of the stockholder as a sale of his stock. If the corporation distributes an amount in partial retirement of its capital stock, the amount thereof is to be considered as a return of capital, and taxable only if, and to the extent that, it exceeds the basis of the stock.

(2) It is provided in the last sentence of section 201 (c) of the proposed bill that amounts distributed in partial liquidation of a corporation shall not, to the extent that they are properly chargeable to capital account, be treated as earnings and profits for the purpose of determining the taxability of subsequent distributions by the corporation. No similar provision is contained in the existing law, although the provisions of the bill represent what is probably the correct construction of the existing law and unquestionably what is in accord with business practice.

Conference Report. House Report 844, 68th Congress, First Session, House Reports Vol. 4, statement of managers on part of the House at page 14.

> "Amendment No. 2. The House Bill provided that the gain from a liquidating dividend to the extent of earnings and profits accumulated by the corporation since March 1, 1913, should be treated as a dividend subject to the surtax rates. The Senate amendment strikes out this provision with the result that a liquidating dividend is to be treated as a sale of stock and taxable as a gain resulting from the sale of property and the House recedes."

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 239

JAMES A. RHEINSTROM, EXECUTOR UNDER THE WILL OF MINNA W. RHEINSTROM, DECEASED, PETITIONER

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE

No. 240

FIRST NATIONAL BANK, CINCINNATI, OHIO, TRUSTEE UNDER THE WILL OF KARL KIEFER, DECEASED, PETITIONER

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 60–67) is reported in 33 F. Supp. 917. The opinion of

the Circuit Court of Appeals (R. 94-105) is reported in 125 F. (2d) 790.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on February 13, 1942 (R. 93–94) A petition for rehearing, filed March 14, 1942 (R. 107), was denied on April 17, 1942 (R. 139). The petition for writs of certiorari was filed July 16, 1942. Jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1914, a corporation reduced its capital stock by cancelling shares of its common stock *pro rata* between the two holders, and transferring the amount of the reduction, $122,000, from common stock to surplus. This sum was later transferred to a new account designated "paid-in surplus". In 1934 the corporation distributed $122,000 to its stockholders in addition to paying a dividend of $90,000. The company's earnings for 1934 were more than sufficient to pay both distributions.

The question is whether the payment of $122,000 was a distribution in partial liquidation under section 115 (a) and (i) of the Revenue Act of 1932, or whether it was taxable as a dividend under section 115 (a) and (b) or (g) of the act.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set forth in the Appendix, *infra,* pages 15–18.

STATEMENT

These cases involve different taxpayers, but present the same question, arising from the same facts. Separate refund suits were brought in the District Court (R. 1–6, 71–76), and the cases were heard separately. They were submitted together, however, and disposed of by the District Court in combined findings of fact and combined conclusions of law (R. 60–67, 87). Judgments were entered for the Collector (R. 67–68, 88). By stipulation the cases were presented to the Circuit Court of Appeals for review on the same record (R. 89–91); the judgments of the District Court were there affirmed (R. 93–94).

The facts found by the District Court may be summarized as follows (R. 94–96):

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908. It had an authorized capital of $500,000, consisting of 3,000 shares of common stock and 2,000 shares of preferred stock, each with a par value of $100 per share. One thousand five hundred shares of common stock and 420 shares of preferred stock were fully paid for, and the total paid-in capital amounted to $192,000. (R. 60–61.) Karl Kiefer and Minna W. Rheinstrom each owned 748 shares

of the common stock (R. 61). The remaining four shares were held in the names of others to qualify them as directors. Kiefer owned all of the outstanding preferred (R. 63).

On November 30, 1914, the directors authorized a reduction of the corporation's authorized capital stock from $500,000 to $70,000. The preferred stock was reduced to $42,000, represented by 420 shares (the amount previously issued), and the common stock was reduced to $28,000, represented by 280 shares. A certificate of reduction of capital stock was filed with the Secretary of State of Ohio, and each of the two principal owners thereupon received new certificates for 138 shares of common in exchange for the original 748 shares. (R. 61.)

This transaction was reflected on the books of the company by reducing the value of the common stock account from $150,000 to $28,000 and transferring the difference of $122,000 to the surplus and undivided profits account, increasing the latter from $31,006.80 to $153,006.80. In 1921 the $122,000 was again transferred to a new account designated as "paid in capital", but no actual distribution of any kind was made, and there was no physical segregation of assets nor any other action taken in regard to the capital stock reduction until 1934. (R 61.) In 1934 the company, in addition to the payment of a dividend of $90,000, disbursed $122,000 to the stockholders and cancelled

the "paid in surplus" account. The payment was designated as one which arose by the reduction of the common stock in 1914. Half of this sum, amounting to $61,000, was distributed to Minna Rheinstrom (whose executor is the petitioner in No. 239), and the other half to the beneficiaries under the will of Karl Kiefer (including the petitioner in No. 240). (R. 61–62.)

The corporation's earnings for the year 1934 were more than sufficient to pay the $90,000 dividend and the $122,000 (R. 62). Assessments were made against the taxpayers on the theory that the distribution of the $122,000 was a taxable dividend.

The District Court rejected the contention of the taxpayers that the distribution was a partial liquidation under section 115 (c) and (i) of the Revenue Act of 1934. The court appears to have proceeded on the theory that the reduction of the stock in 1914 and the distribution in 1934 were separate transactions. It concluded that under section 115 (b) the 1934 distribution must be presumed to have been made from available earnings, and accordingly that the distribution was a dividend under section 115 (a).

The Circuit Court of Appeals concluded that the evidence sustained the finding that the distribution was a taxable dividend (R. 105). Proceeding upon the assumption that the distribution was made in a cancellation of the common stock, the

court held that it was "essentially equivalent to the distribution of a taxable dividend" within the meaning of section 115 (g) of the act and therefore properly taxable as such.

ARGUMENT

1. In the disposition of this case, it is immaterial whether the theory of the Circuit Court of Appeals or that of the District Court is adopted; for whether the distribution in 1934 was made in cancellation or redemption of the common stock, or not, a decision that the funds are taxable as a dividend follows from the facts found by the court below.

If the 1934 distribution was a transaction separate from the reduction in the corporation's capital stock 20 years before, as the District Court appears to have regarded it, the decisive issue is whether earnings were distributed within the meaning of section 115 (a). The corporation had current earnings in 1934 in excess of the amount of the distribution, and section 115 (b) establishes a conclusive presumption that "every distribution is made out of earnings or profits to the extent thereof, and from the most recent accumulated earnings or profits." Accordingly, irrespective of the designation given to the distribution by the parties, there was a distribution of earnings and hence a dividend within the plain meaning of the statute and the settled course of authority. *Leland* v. *Commissioner,* 50 F. (2d)

523 (C. C. A. 1), certiorari denied, 284 U. S. 656; *Baker* v. *Commissioner,* 80 F. (2d) 813, 815 (C. C. A. 2); *Faris* v. *Helvering,* 71 F. (2d) 610 (C. C. A. 9), certiorari denied, 293 U. S. 584.

The Circuit Court of Appeals approached the problem upon the alternative theory that the distribution in 1934 was made in cancellation or redemption of the common stock. In this posture of the case, the distribution was precisely the kind which section 115 (g) is designed to tax as a taxable dividend. The situation here was almost identical with the example given in the committee reports accompanying the Revenue Act of 1926, in which the provisions of section 115 (g) were first adopted as section 201 (g) thereof. The report of the Senate Committee on Finance stated (S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 332, 344)):

> Section 201 (g): It has been contended that under existing law a corporation, especially one which has only a few stockholders, might, without resorting to the device of a stock dividend, be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders,

> for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus. The subdivision as rewritten by the House bill is intended to make clear that such a transaction is taxable and the committee approves the provision, which obviously does not apply in cases of complete liquidation of all the stock of the corporation.

See also H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939–1 Cum. Bull. (Part 2) 315, 318); Statement of the Managers on the Part of the House, H. Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 361); Regulations 86, Art. 115–1 to 115–9, Appendix, *infra*, pp. 16–18.

2. The action of the Circuit Court of Appeals, in deciding the case upon this alternative theory, involved no departure from the proper course of judicial procedure. It is clear that an appellate court may sustain the decision of a lower tribunal upon a different legal theory. *Bondholders' Committee* v. *Commissioner*, 315 U. S. 189, 192; *Le Tulle* v. *Scofield*, 308 U. S. 415, 421; *Helvering* v. *Gowran*, 302 U. S. 238, 245.[1] Although the question

[1] It may be observed that although the opinion of the District Court did not advert expressly to section 115 (g), it quoted (R. 64) from *Commissioner* v. *Champion*, 78 F. (2d) 513 (C. C. A. 6), which involved the application of section 115 (g). Moreover, the taxpayers' brief discussed cases involving section 115 (g) (Br. 27–29); and this section, to-

whether a distribution is "essentially equivalent to the distribution of a taxable dividend" has ordinarily been regarded as one of fact,[2] the Circuit Court of Appeals in reaching its decision here did not, as asserted by the taxpayers, make such a finding of fact. The court concluded that the evidence supported the District Court's finding that the distribution was a taxable dividend (R. 105). The District Court's determination that the transaction was not a partial liquidation, but a taxable dividend, necessarily embraced a determination that the distribution was "essentially equivalent to the distribution of a taxable dividend." The District Court said (R. 64–65):

> In the case at bar beyond the reduction in the number of shares of common stock and the transfer of $122,000 to surplus at the expense of the common stock account, nothing was done even remotely suggesting partial liquidation. But on the contrary this $122,000 was retained in the business actively working for twenty years helping produce the splendid earnings and constant annual dividend record as shown by defendant's Exhibit H, until 1934, the earn-

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gether with the corresponding Treasury Regulations, was included in the statement of the relevant statutory provisions in the Appendix to the Government's brief (Br. 24, 27–28).

[2] See, *e. g.*, *Commissioner* v. *Babson*, 70 F. (2d) 304 (C. C. A. 7), certiorari denied, 293 U. S. 571; *Hirsch* v. *Commissioner*, 124 F. (2d) 24 (C. C. A. 9); *Hyman* v. *Helvering*, 71 F. (2d) 342 (App. D. C.), certiorari denied, 293 U. S. 570; cf. *Goldstein* v. *Commissioner*, 113 F. (2d) 363 (C. C. A. 7) (mixed question of law and fact).

> ings for that year alone being more than sufficient to pay $90,000 dividend plus the $122,000.

Obviously no purpose would have been served by sending the case back for a specific finding in the language of section 115 (g). Cf. *United States* v. *Wells*, 283 U. S. 102, 120. In the light of the facts specifically found, moreover, the conclusion that the distribution was "essentially equivalent to the distribution of a taxable dividend" followed by necessary implication, if not as a matter of law, and it was properly within the province of the appellate court to draw this conclusion. Cf. *United States* v. *Wells, supra;* see *Bogardus* v. *Commissioner*, 302 U. S. 34, 38–39; *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 491.

3. There is no conflict between the decision below and the cases cited by the taxpayer: *Commissioner* v. *Brown*, 69 F. (2d) 602 (C. C. A. 7), certiorari denied, 293 U. S. 570; *Commissioner* v. *Rockwood*, 82 F. (2d) 359 (C. C. A. 7); *Commissioner* v. *Cordingley*, 78 F. (2d) 118 (C. C. A. 1); *Commissioner* v. *Quackenbos*, 78 F. (2d) 156 (C. C. A. 2); *Patty* v. *Helvering*, 98 F. (2d) 717 (C. C. A. 2). The question involved in these cases was whether a distribution made in cancellation or redemption of stock which has been issued as a stock dividend was taxable under section 115 (g). In none of these cases did the corporation have earnings at the time of the distribution, other than the earnings which had been capitalized upon the

issuance of the stock dividend. In these circumstances, the cases cited have held that section 115 (g) was not applicable where the original stock dividend had not been issued as part of a tax avoidance plan. But as the Circuit Court of Appeals made clear in *Patty* v. *Helvering, supra,* this rule has no application where, as in the instant case, a corporation has earnings at the time of the distribution upon which earnings section 115 (b) could take hold. The line of cases cited by taxpayer has recently been distinguished on this ground in *Flanagan* v. *Helvering,* 116 F. (2d) 937 (App. D. C.), which involved facts substantially similar to those at bar.

4. None of the remaining grounds advanced by the taxpayers in support of the petition requires more than passing consideration. *Dicta* in the opinion below on the question whether it is essential to a "partial liquidation" under section 115 (i) that a winding up of the business be contemplated, or that a policy of contraction be manifested (see Pet. 14–16), plainly afford no ground for review.

There is implicit in the decision below a determination that section 115 (g) is applicable to a distribution made during the taxable year, irrespective of the time the stock was cancelled. The taxpayers contend that in view of the express prohibitions against retroactivity contained in sections 201 (g) and 115 (g) of the 1926 and 1928 acts, respectively, an important question is pre-

sented (Pet. 13–14).[3] But the absence of a conflict is conceded. And there is no merit to the contention that the decision is erroneous for this reason, since the taxable event with which section 115 (g) is concerned is the *distribution*, and that took place within the tax years governed by the Revenue Act of 1934. The cancellation or redemption was not completed until that year.

The argument that the distribution in 1934 was made in payment of a "debt", owing from the corporation to its stockholders by reason of the reduction in stock (Pet. 16–17), was expressly rejected by the District Court (R. 65); patently such a characterization of the payment, even if it were correct, is not of significance in considering the application of section 115 (g). The question

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[3] Section 201 (g) of the Revenue Act of 1926 and Section 115 (g) of the 1928 Act provide:

> In the case of the cancellation or redemption of stock not issued as a stock dividend this subsection shall apply only if the cancellation or redemption is made after January 1, 1926.

The purpose was to avoid retroactivity. S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 332, 344). Since the Revenue Act of 1932, this provision has no longer been contained in the statute. The committee reports accompanying the 1932 act stated that it was unnecessary since the income tax title of the act applied only to 1932 and subsequent years. H. Rep. No. 708, 72d Cong., 1st Sess., p. 22 (1939–1 Cum. Bull. (Part 2) 457, 473); S. Rep. No. 665, 72d Cong., 1st Sess., p. 31 (1939–1 Cum. Bull. (Part 2), 496, 518. Revenue Act of 1932, Sec. 1. Section 1 of the Revenue Act of 1934 provides that its income tax provisions "shall apply only to taxable years beginning after December 31, 1933."

under section 115 (g) does not turn upon the legal definition which might be given to the payment for cancellation or redemption in determining the rights of the parties *inter se,* but is solely whether the distribution was "essentially equivalent" to a taxable dividend. By the same token, there is plainly no occasion for review of the Circuit Court of Appeals' determination that there was no reversible error in the District Court's exclusion of evidence proffered to show an intention in 1914 supporting this theory of a "debt".

Also without substance is the contention that the distribution in 1934 was not a dividend because the capital reduction in 1941 gave Kiefer, as holder of all the preferred stock of the corporation, an enhanced right to share in the assets of the corporation upon liquidation (based on the claim that the preferred would participate share for share with the common) (Pet. 17–18). Equality of treatment among shareholders is not a prerequisite of a dividend. *Lincoln Nat. Bank* v. *Burnet,* 63 F. (2d) 131 (App. D. C.); *Hirsch* v. *Commissioner,* 124 F. 2d) 24, 29 (C. C. A. 9). And, in any event, the $122,000 distribution in 1934 was paid equally to the two principal stockholders of the Kiefer Company, according to their respective common-stock interests.

Finally, taxpayers make the contention (Pet. 20–22) (applicable only with respect to the taxpayer in No. 240) that the Court should review the

question whether a distribution to a trust, which would not be income as between life tenant and remainderman and hence not taxable to the life tenant, may be taxed as income to the trust. It is well settled, however, that it may. *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; *Burdick* v. *Commissioner,* 76 F. (2d) 672 (C. C. A. 3); S. M. 4241, IV–2 Cum. Bull. 191.

CONCLUSION

The decisions below are correct and present no conflict or other occasion for further review. It is therefore respectfully submitted that the petition for writs of certiorari should be denied.

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AUGUST, 1942.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. * * * In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this sec-

tion for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 115-1. *Dividends.*—The term "dividends" for the purpose of Title I * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. * * *

ART. 115-2. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made

out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

* * * * *

ART. 115–5. *Distributions in liquidation.*— Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The phrase "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

* * * * *

ART. 115–9. *Distribution in redemption or cancellation of stock taxable as a dividend.*— If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a dis-

tribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

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Supreme Court of the United States

OCTOBER TERM, 1942

No. 239

JAMES A. RHEINSTROM, EXECUTOR UNDER THE WILL OF MINNA W. RHEINSTROM, DECEASED, PETITIONER,

v.

THOMAS J. CONNER, COLLECTOR OF INTERNAL REVENUE.

No. 240

FIRST NATIONAL BANK, CINCINNATI, OHIO, TRUSTEE UNDER THE WILL OF KARL KIEFER, DECEASED, PETITIONER,

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On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit

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REPLY BRIEF OF PETITIONERS IN SUPPORT

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1. The example quoted on pages 7-8 of Respondent's brief is not apposite under the facts here, because the cancellation here occurred in 1914, long before the earnings accumulated, and therefore could not have been made with any thought to use it as a device to distribute earnings.

2. It does not meet petitioners' Reason I (Pet. 9-11) to say that an appellate court may sustain a decision of a lower tribunal on a different theory (Resp. Br. 8). The

Court below went much farther than that. It decided the cases on an issue raised *sua sponte* by it, although never urged or mentioned at any time by either side or by the trial court, and the petitioners, therefore, never had an opportunity to meet it, or to present evidence in refutation thereof. The very cases cited by the respondent bear out this distinction. In *LeTulle* v. *Scofield*, 308 U. S. 415, the Court allowed certiorari on this very ground. It did not have to pass upon it on the merits, however, as the decision appealed from was found to be correct on other grounds. In *Helvering* v. *Gowran*, 302 U. S. 238, 245, where the Court permitted the Government to urge a new theory, it was very careful to permit the taxpayer to reopen the case before the Board of Tax Appeals to present any additional facts which might affect the result. It is clear from these decisions and from the decisions cited in the Petition for certiorari, that this Court has always been careful to protect a litigant's right to his day in court.

Respondent admits that the question of whether a distribution was "essentially equivalent to the distribution of a taxable dividend" is one of fact (Resp. Br. 9). It is idle to say that the Circuit Court of Appeals did not make such a finding. The Circuit Court of Appeals necessarily made such a finding by its conclusion. To make a finding, no court has to say "We hereby find." Where a conclusion is in effect a finding, it is none the less a finding even though it may not be expressly described as such by the court. It is clear from reading the District Court's findings and conclusions that it had no thought of Section 115 (g). It was erroneously of the opinion that to have a partial liquidation under Section 115 (i), a closing out or contraction of the business was necessary (R. 63-4), and found that the distribution in question was therefore conclusively presumed to be dividends from earnings under paragraphs (a) and (b) of Section 115. Nor is it correct

to say (Resp. Br. 10) that the findings of the District Court require the conclusion that the distribution was "essentially equivalent to the distribution of a taxable dividend," and that therefore the Circuit Court of Appeals was justified in so concluding. The primary facts as found by the Court of Claims in *Foster* v. *United States,* 303 U. S. 118 (see 17 Fed. Supp. 191, 192), are quite similar to those in the cases at bar. Yet this Court affirmed the conclusion that a partial liquidation had taken place. It would have been the function of the District Court to make the finding of ultimate fact as to whether or not the cancellation and distribution in question were essentially equivalent to the distribution of a taxable dividend, if that had been an issue in the case, but not having so found, it was not within the province of the Circuit Court of Appeals to usurp that function.

3. Respondent's effort (Resp. Br. 10-11) to avoid the conflict in the Circuits referred to under petitioners' Reason II (Pet. 11-13) is unsound. The factual distinctions in the cases sought to be found by the respondent are irrelevant or nonexistent. The point of the conflict was the question of the materiality of motive in the applicability of Section 115 (g). The contention of respondent that a distribution in partial liquidation exempted from Section 115 (g) cannot exist when there are uncapitalized earnings present, is contrary to the decision of *Foster* v. *U. S.*, 303 U. S. 118, where there was a large earned surplus existing at the time the stock involved there was cancelled.

4. The decision of the courts below on the question of partial liquidation was not mere dicta (Resp. Br. 11). The District Court's judgments were based on that court's erroneous conception of the necessary requirements of partial liquidation under Section 115 (i) (R. 63-4), and

the Circuit Court of Appeals affirmed that holding (R. 104-5).

5. The respondent is in error in arguing (Br. 12) that the prohibition against retroactivity on the application of Section 115 (g) affects *distribution only*. Section 115 (g) provides:

> "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution *and cancellation* or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend . . ." (Emphasis ours.)

This shows that the time and manner of the *cancellation* is equally as important as the *distribution* in determining taxability.

Congress, in broadening Section 115 (g) to cover stock not issued as a stock dividend specifically limited the application of Section 115 (g) to such stock, to cases where *"the cancellation or redemption is made after January 1, 1926."* (See Pet. 13-14 and notes; also Resp. Br. 12, note.) The prohibition thus specifically covers cases of cancellation without respect to when the distribution is made. The cancellation was complete in 1914, and must have been, because the shares were turned in and the authorized capital was reduced at that time, and the company thereby became obligated to make the distribution. Congress, by the language it employed, showed that it considered the *cancellation as something separate* from the distribution, and that Section 115 (g) was to be applicable *only if the cancellation occurred after January 1, 1926.*

6. Respondent's contention (Br. 12-13) that even if the distribution in 1934 was in payment of a debt due the stockholders by reason of the reduction of capital and cancellation of the stock, that would not affect the appli-

cation of Section 115 (g), is not understandable. Payment of a real debt and a distribution under Section 115 (g) are necessarily mutually exclusive. If the cancellation were a tax evasion device, no real debt would be created. That is an additional reason why the exclusion of the proffered evidence to show the existence of this debt in fact as well as in law, was prejudicially erroneous. In the seven years that this matter has been in controversy, the Government has not been able to suggest any reason that the stockholders might have had for the reduction in capital and the cancellation of the 1220 shares other than that sought to be shown by the proffered testimony.

7. Respondent's discussion (Br. 13) of the resultant *nunc pro tunc* gift of $36,600 to Karl Kiefer forced upon Mrs. Rheinstrom by the decisions below, misses the point entirely. Petitioners' purpose in showing that such a gift would be forced upon Mrs. Rheinstrom by the decisions below, was to prove that a very real change did take place in the proportionate ownership of the corporation by the cancellation of the 1220 shares of common stock, and to demonstrate that the explanation given by the proffered testimony for the reduction in capital was not only credible but necessarily correct, as it would be inconceivable to suppose that one stockholder, for no reason at all, would make a gift worth at least $36,600 to another, of a one-fifth interest in the ultimate ownership of a corporation. While it is true that Mrs. Rheinstrom received one-half of the $122,000 distribution, made in 1934, if the respondent prevails, this will have to be charged against the earnings of the corporation, and the surplus created by the reduction in capital will be distributable upon final liquidation, at which time the Kiefer heirs, by reason of their preferred stock holdings, will receive $36,600 of Mrs. Rheinstrom's share. (See Pet. 17-18.)

8. Respondent (Br. 13-14) also misses the point of petitioners' Reason VII (Pet. 20-21). Petitioners concede that capital gains or unusual dividends, involved in the cases cited by respondent, may be subject to income taxes in the hands of a trustee, even though considered principal under the trust. In the cases at bar, however, if the distribution was not a return of capital, but dividends from earnings, then the life tenant was entitled to receive the same under the trust, and she, and not the trustee, should pay the tax thereon. The distribution was either a return of capital or it was not. If it was, it is not taxable at all; if it was not, the life tenant, not the trustee, should pay the tax.

CONCLUSION

For the reasons stated in the petition, it is respectfully prayed that the writs issue.

Respectfully submited,

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Supreme Court of the United States

No. 239

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

No. 240

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

PETITIONS FOR REHEARING ON PETITIONS FOR WRITS OF CERTIORARI TO REVIEW JUDGMENTS OF THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

To the Honorable Chief Justice and Associate Judges of the United States Supreme Court:

The petitioners respectfully apply to this Court for a rehearing of their petitions for writs of certiorari denied by this Court as of October 12, 1942:

In denying the petitions for writs of certiorari in these cases, this Court has declined to consider several novel questions of great importance, regarded as crucial by certain Courts of Appeal (see Petition for Certiorari, pp. 12, 13) as well as by the Bar generally.

We appreciate the natural human possibility that this Court, overburdened with the task of disposing of the mass of petitions filed during the summer recess, might not have had the chance to consider sufficiently the questions or their importance. In this application we shall stress those questions in which we think this Court will be most concerned.

In denying this writ of certiorari, this Court

I. Permits the Court of Appeals to give retroactive effect to a taxing statute contrary to express Congressional intent. The whole point in this case revolved about the fact that the cancellation of the stock and the consequent partial liquidation occurred long before the taxing statute (Section 115 of the Internal Revenue Code) was passed.

II. Section 115g of the Internal Revenue Code, designed to prevent schemes to evade taxation, applies expressly to cases where a *cancellation* of stock was had in order to effectuate a scheme. To apply the prohibition of the statute to "distribution" only, where the cancellation itself was innocent is to rewrite the statute. If it is conceivable that Congress might have covered "distribution" alone into the interdictions of the statute, had the matter been called to its attention, then we have a *casus omissus* which the courts should not supply. The matter is for the Legislature. An example of an analogous omission and the improper supply by the lower courts of corrective legislation was *Maas* v. *Higgins,* relating to an inheritance tax on income received by an executor during the running of the one year optional plan of appraisement. This Court allowed

certiorari and corrected the assumption of legislative power by the Court of Appeals in *312 U. S. 443* (Mr. Justice Black and Mr. Justice Douglas dissenting). This Court said, as we respectfully state the Court should say here:

> "If Congress intended the result for which the Government contends . . . it would have been a simple matter to so state."

III. (a) The Court of Appeals below denied a rehearing in opposition to the express holding of this Court (Petition, p. 11). This Court has held that when a Court of Appeals decides a case on a point not raised by the litigants, a rehearing is in order to enable the party prejudiced to have his day in court. The Court below decided these cases under favor of Section 115g of the Internal Revenue Code, which section the Government sedulously avoided, nor was the section ever mentioned until in the opinion of the court below.

This Court as late as 1939 has granted certiorari on this very ground (*LaTulle* v. *Scofield,* 308 U. S. 415).

(b) The Court of Appeals presumed to find facts, not found by the trial court, and decided the case on a ground never raised or argued. Courts of review do not find facts. The primary facts were stipulated and the statute itself draws the ultimate fact.

IV. The statute itself defines partial liquidation to be the result of a cancellation of stock. (Section 115i.) There is no room for the Court to "find" as a fact whether or not the liquidation as such is "properly" chargeable to capital account, if the propriety of the cancellation itself is not challenged, and the amount of the cancellation money is not in issue.

V. The decision of the court below is at variance with the decisions of other Courts of Appeal, as the lower court concedes. (R., p. 97 ff. Also Pet., pp. 12, 13.) See *Patty* v.

Helvering, 98 Fed. (2d) 717, 719, wherein L. Hand, J., remarked,

> "We shall continue to follow *Com'r* v. *Quackenbos,* 78 Fed. (2d) 156, until the Supreme Court makes authoritative a different interpretation."

The appellants are stockholders in a corporation which in 1914, long before Section 115 was passed, reduced its capital, called in and cancelled $100 par value stock under State authority, received the stock from the stockholders and issued new stock of the same par value, but a smaller number of shares. There is nothing in the record to show bad faith respecting this cancellation. The operation necessarily involved a debt to the stockholders whether the corporation's books set up that debt properly or not. There can be no question of motive or interest in respect to this cancellation, one way or the other, so far as Section 115 of the Internal Revenue Code or any section of that code is concerned, for the simple reasons that the sections in question had not been passed or thought of at that time. One cannot intend to evade a law that does not exist. So far as Section 115 is concerned, or any other law or moral, that cancellation was perfectly innocent of any purpose to evade the Revenue Laws or any other law.

So much is conceded by the lower court at least regarding the *cancellation* alone. That being so, there is no room for any finding of fact by the Circuit Court of Appeals (assuming that that court had any right to find facts, which in our brief we have shown by this Court's holdings, it has not) as to the evasion of the taxing laws, as envisioned by Section 115g. The cancellation being thus innocent, there was no fact left for the courts below to pass upon under Section 115g. All of the cases where stock *not originally issued as a stock dividend* was cancelled and Section 115g was held to apply, were cases where the *cancellation itself*

took place after Jan. 1, 1926, the date of the precursor of the 1934 Section of the Act.

There was left, therefore, if anything was left, which we deny, only one fact for the trial court to find in any construction of Section 115g, and that was whether the *distribution* was innocent under Section 115g. We have insisted that under Section 115g, it is the *cancellation* that must be bad, or at most the cancellation *and* distribution. *Both* have to be part of a scheme to avoid taxation. But passing that point, and postulating now that though the *cancellation* was innocent of any juggling contemplated in Section 115g, and that a debt was thus owed the stockholders but that the trial court had the right to judge the propriety of the *distribution,* we contend, and have contended, and the decisions of this Court bear us out (see Petition, page 16 and note), that any Board of Directors finding itself in possession of funds more than enough to pay any debt or any refund to stockholders which is due them, plus enough more to pay dividends on the stock, has the right to withhold the dividend and pay the debt. Indeed, the creditor stockholders could, if they wished, force the payment of the debt.

No court has the right, though it have the power, to find as a fact merely from evidence of the possession of funds more than enough to do both things, that the choice to pay the debt to the stockholders is subversive of Section 115g of the Revenue Code; surely, at least in the case of a cancellation of stock before January 1926, not previously issued as a stock dividend.

This choice constitutes a "partial liquidation" under the statute and by the very terms thereof, and it is expressly protected from taxation as a dividend by Section 115c of that Code. Under that section the phrase "which is properly chargeable to capital account" does not leave to the courts any fact finding authority as to "propriety,"

of the liquidation *as such,* but only as to the amount of it, and here there was no issue as to the amount. *The section itself defines that propriety* when the distribution is relegable to partial liquidation, which by definition in Section 115i of the Revenue Code took place here, and *ex hypothesi* the Board of Directors had the right in this case to relegate the distribution to cancellation of the stock whenever the Board or its creditor stockholders chose, whether in 1914 or in 1934.

This was recognized in *Foster* v. *U. S.,* 303 U. S. 118, where it was to the interest of the Government to recognize the partial liquidation. What is sauce for the goose should be sauce for the gander.

If the distribution is earmarked by the corporation as the payment of a rightful debt contracted before Section 115g was passed, the recipient is receiving capital, not income, and for the lower court to call capital income, is to take property without due process of law, and also to violate the income tax amendment in the Constitution (*Eisner* v. *Macomber,* 252 U. S. 189). But even if the overruling of the *Eisner* case is in the offing, and even if a statute could make capital income for the purpose of taxation, the statute here negatives any such intention when it says in Section 115i:

> "As used in this section 'amounts in partial liquidation' means a distribution by a corporation in complete cancellation of a part of its stock."

None of the factors mentioned by the lower court, such as the continuous possession of enough funds to pay this debt through all the years, or the fact that the corporation used the stockholders' money in the business, or the fact that the stockholders received no interest on their debt, have anything to do with the rightness or wrongness of the *cancellation* of the stock under Section 115, or with the

cancellation *and* distribution to the stockholders of the money that was due them. Neither this Court nor any other court, except the court below, has applied these factors to a cancellation before January 1, 1926, of stock not issued as a stock dividend.

It all comes down to this: Section 115g plainly seeks to reach any *cancellation* of stock *cancelled* with the *purpose* of later paying for that cancellation out of otherwise taxable profits. In this case there was no justiciable possibility of such an interdicted purpose, because the statute taxing the cancellation money had not yet been passed.

It is no doubt true that the lower courts probably felt that because such a long time had elapsed before the Directors elected to pay this debt, and because they picked out a year when the corporation made a great deal of money, somehow or other the stockholders who received this money so belatedly ought to pay a tax on it as a dividend, and perhaps the statute should have been written to provide that they should, if that could be done constitutionally. Perhaps the statute should have provided in some appropriate form that though a cancellation of stock at the time it was made was not in violation of Section 115g, if payment of the debt was delayed unreasonably long, a belated distribution of the cancellation money should be taxable as a dividend. But our point has always been that the statute makes no such provision, and it is not up to the courts to find facts in violation of the statute, so as to make it read as the courts think it ought to read.

Furthermore, even if the statute had read that way, then the proffered testimony of the plaintiff below should have been admitted for the record, tending to show that the belatedness was *not* unreasonable.

The construction of Section 115g as to whether the evasion of taxes is relegable to the cancellation alone, *or*

whether if the cancellation is innocent, the courts can weigh the validity of the distribution alone has never been passed on by this Court, though various Judges of the Courts of Appeal have hoped that it would be.

We respectfully urge that this Court re-examine the petition for certiorari, and that it take this case and iron out the many inconsistent and cloudy decisions of the various Courts of Appeal as set forth in our brief, inconsistencies which the court below in its opinion recognizes.

Respectfully,

THOMAS C. LAVERY,
A. JULIUS FREIBERG,
Attorneys for Petitioners.

Thomas C. Lavery and A. Julius Freiberg, counsel for petitioners, hereby certify that the foregoing Petition for Rehearing is made in good faith and not for purposes of delay, and on grounds believed to be valid and substantial.

THOMAS C. LAVERY,
A. JULIUS FREIBERG.